Proposal for amending the Parent-Subsidiary Directive: European Commission is waging war against double non-taxation

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On 25 November 2013, the European Commission published its proposal for amending the European Parent-Subsidiary Directive.

In this article, the authors analyse the changes proposed and the objectives set by the European Commission, and critically review the proposal concerned. This article is further intended to give an insight into the impact the proposal may have and to provide an indication on the timing of the implementation of the proposed changes.

The European Parent-Subsidiary Directive: a milestone on the road to a single European market

The Parent-Subsidiary Directive (the "PSD") was introduced in 1990 in order to strengthen the European market by ensuring that European companies can distribute profits to their European parent company without unnecessary (fiscal) obstacles. The reason for this is that, in the years preceding the introduction of the PSD, the creation of a single European market was found to be accompanied by the (re)grouping of European companies, aimed at enhancing their (joint) competitive position. One key element in this respect is the possibility to get the profits of the various subsidiaries to stream up to the central (European) parent company so as to fund, at that level, the financial costs of the group or to safeguard the necessary profits to be able to finance the dividend policy pursued by the group.

The PSD requires member states to include in their legislation a provision that profits distributed by EU companies to their EU parent company may not be taxed at source in the country where the subsidiary is established (exemption from source taxation on distributed profits) and also that the parent company must avoid double taxation of dividends received. To that end, the PSD provides that such received distributed profits:

- either shall not be taxed (exemption at the level of the parent company) – most member states, including Belgium, have opted to exempt distributed profits;
- or may be taxed at the level of the parent company but, in such cases, a tax credit shall be granted for the tax paid by the subsidiary on the distributed profit (i.e. tax credit for the parent company).

Since its introduction, the PSD has significantly stimulated the integration of European businesses as well as their competitive position in an increasingly globalising economy.

The European initiative to amend the PSD forms part of the broader social debate about "Base Erosion and Profit Shifting"

In the past few months, the taxation of multinational enterprises has become the topic of comprehensive social debate. Some stakeholders, including the OECD, have found that the current international tax system is no longer in line with the manner in which enterprises are organised (globally or regionally integrated value chains, importance of intellectual property, ever-increasing significance of the digital economy, etc.). The conclusion of this debate seems to be that the current international rules on corporate taxation would result in some multinationals not paying sufficient income tax in well-defined situations because certain parts of the profits earned by those multinationals are not adequately taxed across borders. The G20 countries have recently taken the lead in this debate and are insisting that certain pressure points in the international tax system be remedied. To that end, those countries have mandated the OECD to develop proposals and recommendations (what is referred to as the "Base Erosion and Profit Shifting" or "BEPS" initiative).

Early 2013, the OECD prepared an analysis of what, in its view, are the pressure areas in the international tax system. The conclusion of its analysis has been included in the OECD Report on BEPS, which was issued in February 2013. Next, on 19 July 2013, a 15-part action plan was presented to address the identified pressure areas. In action point 2, the OECD makes it its aim to neutralise the undesired effects of differences in qualification between countries (the “hybrid mismatches”).

This broader social debate is also the context in which the initiative taken by the European Commission should be viewed. The proposal, however, originates from the work done by the European Code of Conduct Group, a group of experts tackling the problems that exist in relation to taxation of EU companies. In 2009, that expert group concluded that, in a number of cases, part of the income of an EU company is not actually taxed because a qualification difference may arise between countries. In order to get a better view of the nature of those qualification differences in a European context (as well as the impact of those qualification differences), the European Commission announced, in November 2011, it would organise a public consultation round. During that consultation round, all stakeholders could provide information on the qualification differences they were faced with, and outline their concrete impact.

In the same period as the one of the consultation round, the European Council and the European Parliament concluded that an adaptation of the European directives seems appropriate to eliminate certain qualification differences so as to establish a more balanced taxation for EU companies. On 6 December 2012, the European Commission issued an action plan to meet the request of the Parliament and the Council. One of the action points of the plan concerns addressing qualification differences which can arise in connection with financial instruments (“hybrid loans”). The proposal for amending the PSD is the step the European Commission has now undertaken as part of this action plan.

Although the initial discussions on amending the Parent-Subsidiary Directive were held before the BEPS initiative, we see that the European Commission and the European Parliament have been supported by BEPS in further developing their initiative. Unsurprisingly, the European Commission explicitly refers to the BEPS initiative in its 25 November 2013 press release accompanying the proposed changes to the PSD.

What is the proposal about: double non-taxation and hybrid financial instruments

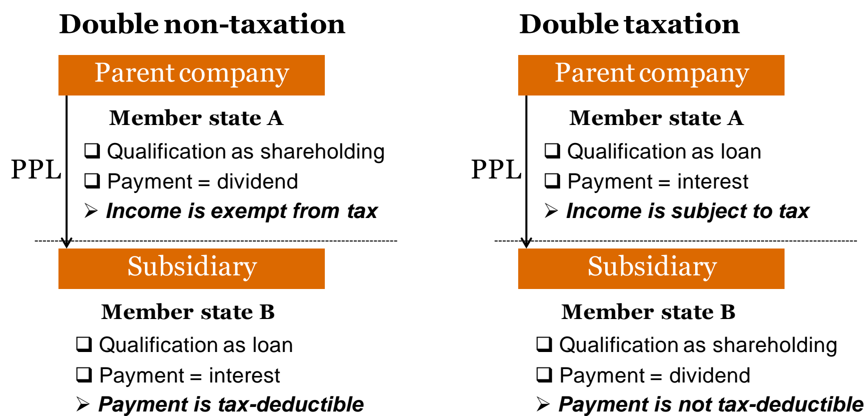
For a proper understanding of the proposal of the Commission, importantly, the essence of double non-taxation in connection with hybrid financial instruments needs to be outlined. Although qualification differences between countries can be relevant at various levels, the European Commission explicitly refers to the difference in qualification, between countries, of the payment made in relation to financial instruments (e.g. loans or instruments to hedge exchange rate risks), which suggests that such instruments are the main object of the proposal.

Double non-taxation concerns a situation where, due to cross-border transactions and the application of the different rules of law in the countries concerned, certain parts of profits earned by companies remain untaxed. Double non-taxation can be the consequence of differences in international tax rules (e.g. different definition of loan or shareholding) or specific rules introduced by certain countries to submit certain income parts to either no taxation or reduced taxation (e.g. introduction of incentives to develop intellectual property in the sense that certain royalties received by a company in that country are taxed less heavily). The causes underlying double non-taxation can also give rise to double taxation.

Hybrid financial instruments are financial instruments which have a different qualification in the countries concerned. A well-known example of a hybrid financial instrument is the “profit-participating loan”. A profit-participating loan (“PPL”) is a loan having a long duration (usually exceeding 50 years) under which the payment owed by the borrower depends on the (annual) profit the borrower achieves. Depending on the legal system in place in the country concerned, such financial instruments can be given a different qualification:

- Qualification as a loan: in countries such as Belgium, France, Spain, PPLs are typically classified, under civil law, as a loan, and, consequently, the payment made in relation to the loan constitutes interest.
- Qualification as a shareholding: in other countries, such as the Netherlands and Luxembourg, PPLs can be classified, under the law applicable there, as a shareholding in a subsidiary considering the long duration and the fact that the level of the payment is dependent on profit. On the basis of the legal system in place in those countries, such instruments can be considered similar to a shareholding in a subsidiary and, consequently, the payment made in relation to this instrument can be considered a dividend.

Depending on the situation, such qualification differences can result in either double taxation or double non-taxation:



Proposal for amending the PSD in order to balance out the tax effects of qualification differences

The proposal of the European Commission is twofold, and it includes, on the one hand, the introduction of a general anti-abuse provision in the PSD and, on the other hand, a change to the wording of the directive so as to require the member states in specific cases to tax received distributed profits (and hence no longer tolerate exemption of such income). In this respect, it is important to point out that what follows below is at this stage a proposal for introducing amendments, meaning that this proposal will not necessarily be identical to the amendments which may ultimately be approved.

First, the proposal includes the introduction of a general anti-abuse provision in the PSD. On this point, the proposal reads that member states should not allow the benefits of the PSD in the case of so-called “artificial arrangements” that defies the spirit and purpose of the PSD. The proposal defines artificial arrangements as structures which do not reflect economic reality. It lists situations which give rise to classification as an artificial arrangement, in which case, therefore, the benefits offered under the PSD should be denied:

> (a) the legal characterisation 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 which would not ordinarily be used in a reasonable business conduct;
> (c) the arrangement includes elements which have 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.

By introducing the anti-abuse provision, the European Commission strives to avoid situations it considers as abuse of the PSD. The current wording of the PSD only includes a provision allowing national authorities to lay down anti-abuse provisions (in domestic legislation or in treaties) without further detailing what an anti-abuse provision may or should look like.

The second amendment is aimed at avoiding double non-taxation based on a difference in qualification on the part of the borrower and the issuer of a hybrid financial instrument, respectively. The proposal reads that a parent company should refrain from taxing profits ***to the extent that such profits are not deductible by the subsidiary of the parent company***. This amendment is intended to avoid that the member state of the parent company grants exemption from taxation on received distributed profits if the member state of the subsidiary considers the attribution a deductible interest expense. Consequently, the double non-taxation in Figure 1 above would cease to exist.

Necessity and desirability of a general anti-abuse provision in the PSD?

As indicated, the PSD in its current form already explicitly allows the member states to introduce provisions to avoid any abuse of the PSD, without, however, providing any guidance as to what such provision should look like. The question that arises then is to what extent there was any necessity to provide for a general anti-abuse provision in the PSD.

Looking at the legislation in place in the various member states, we find that quite a few – not to say all – member states have introduced anti-abuse provisions in recent years:

- General anti-abuse provisions have been introduced in virtually all member states like in Belgium.
- Denmark has previously applied the PSD widely in its domestic legislation, by, for instance, not requiring any specific holding period for shares. Denmark did however introduce an anti-abuse provision in its legislation thereby limiting application of the exemption from taxation on received distributed profits: in Denmark, profit distributions are no longer exempted if they have given rise to a deductible expense for the subsidiary. In other words, Denmark holds the view that the current PSD already allows the member states to take effective action against double non-taxation in connection with hybrid financial instruments.
- In its domestic legislation, Germany has introduced so-called "anti-treaty shopping" rules imposing additional conditions for the application of treaty benefits (also those offered under the PSD) in situations where abuse can be involved.
- Recently, France completed an adjustment to the interest deduction rules making interest payments by French companies no longer deductible if the income itself is not taxable at an effective rate of minimum 25% of the applicable French rate. That rule is similar to the Swedish interest deduction rule providing that interest payments by Swedish companies in certain cases are no longer deductible if the interest derived by the ultimate beneficiary is not submitted to an effective tax rate of minimum 10%.

The proposed anti-abuse provision does not actually offer the member states any possibilities which did not previously exist. If the concern of the European Commission was that there was no or little consistency between the various anti-abuse provisions, the introduction of a general anti-abuse provision is a laudable attempt to come to a more streamlined anti-abuse provision.

Knowing that the various member states, once this proposal is adopted, will have to implement this directive into national legislation and that most (if not all) member states already have an anti-abuse provision in place which currently already allows so-called artificial arrangements to be tackled, it can be feared that this anti-abuse rule would come on top of the rules already in place. If that fear becomes reality, the result may be a muddle of anti-abuse provisions which will be partly overlapping and partly supplementary. Clearly, the risk here is that double taxation can arise; how will the local tax authorities react if the various different local anti-abuse rules turn out to lead to a circular reasoning?

A possible scenario is that some countries (e.g. France and Sweden) may consider (interest) payments as deductible only provided that the beneficiary is actually taxed, whilst, in specific cases, the beneficiary will be able to obtain exemption only provided that the payment is not deductible for the subsidiary. The question then is which country will need to back down in such cases, and this in order to avoid the payment becoming both non-deductible and non-exempt. A tie-breaker rule would be very helpful to avoid lengthy discussions on this.

Also the wording of the anti-abuse provision can be criticised because little weight is given to the motive of an enterprise (Was its action principally driven by tax saving?), whereas the European Court of Justice considers this "subjective test" as an indispensable element of an anti-abuse provision. That is why we believe this proposal is rather an encouragement to the member states prompting them to address situations of abuse. Obviously, notions such as "economic substance" and "substance over form" will become crucial in this respect. This message is manifestly consistent with ongoing social developments and expected OECD action with regard to any abuse of tax treaties.

Is the proposed adjustment of the exemption effective to avoid double non-taxation resulting from qualification differences?

The recent discussions and statements clearly show that the European Commission wants to take action in cases where the cause of double non-taxation lies in a difference in qualification between member states of certain income parts.

The adaptation approach chosen by the Commission, i.e. the PSD is adapted in such manner that member states should take specific measures, is a highly effective manner to achieve the result: once this obligation is adopted as part of the directive and is implemented in the domestic legislation of the various member states, this would effectively address the consequences of qualification differences in terms of double non-taxation in the cases intended to be covered. The press release issued on 25 November 2013 most clearly indicates that the proposal obliges the member states to tax distributed profits received from subsidiaries if same distributions were deductible for the subsidiary.

One cannot but notice, however, that, in spite of the clear objective, the wording of the proposal is not entirely clear; it does not say in so many words that member states will be obliged to actually tax those specific profit distributions. In fact, the wording only suggests that exemption may be given only to the extent that the dividend is not deductible for the subsidiary. In our view, the wording could have been clearer by mentioning, for instance, that the qualification the subsidiary has given to the payment must also be followed by the shareholder. In this manner, the proposal would also have directly dealt with situations of double taxation. The current proposal does not offer any solution for situations of double taxation (where, for instance, the subsidiary classifies the payment as a dividend and the shareholder considers it to be interest income). Double taxation is a significant obstacle for European groups and this proposal for amendment of the PSD is thus a missed opportunity to also effectively tackle double taxation.

The scope of the PSD is limited to intra-EU situations. Consequently, this proposal does not solve the double non-taxation issue in cases where the dividend is received by a parent company established outside the EU. As an example, the deduction of hybrid financing related interest paid to a non EU parent company remains out of the scope of this proposal.

The question arises whether adapting the PSD was really necessary to avoid double non-taxation. The Legal Department of the Commission seems firmly of the opinion that member states must currently always exempt received distributed profits, even if they have resulted in deduction for the subsidiary. That firmness of opinion is rather arguable, however, because an explanation of the notion of "profit distribution" in the light of the current objective of the PSD (i.e. prevention of double taxation) would be in favour of not including in such definition any deductible payments on a hybrid loan.

Apparently, the above leads to the conclusion that adapting the PSD is a highly effective manner to oblige member states to counter situations of double non-taxation. However, a seeming lack of completeness and clarity could mean that not all situations will be actually eliminated, but this is something practice will need to show.

And now?

An EU Directive is established by the European Parliament and the European Council, upon a proposal by the European Commission. Such proposal is now available, so the next step is the adoption of this proposal by the European Council and the European Parliament.

The European Parliament has repeatedly pressed for the directive to be reviewed, which is why adoption by the European Parliament can be expected to occur soon.

The (unanimous) approval by the European Council of Ministers is required. From the succession of the various steps undertaken by the European Council as well as the recent communications issued by the European Council, a significant level of consensus for approval of this proposal can already be presumed to exist at the level of the Council. It is, however, unforeseeable whether any moot points will or will not eventually crop up in the approval process, which could finally result in important changes to the proposal before adoption. On the other hand, considering the current lively social debate on taxation of companies, the question is whether any countries would really want to sink this proposal. At the same time, countries keep competing in the tax arena, so maybe some member states will want to slightly change the wording in a number of respects. If no consensus can be reached after all, there will still be the possibility of enhanced cooperation, but this option does not actually seem very realistic because the very and only solution for the double non-taxation issue within the EU is to have common rules for all member states.

Although it is difficult to properly assess this, it seems realistic that the proposal launched by the Commission (with or without certain changes in wording) will be adopted in the next 12 to 18 months. Consequently, the proposed timing of 31 December 2014 for implementation in domestic legislation is, admittedly, ambitious but not impossible.

The ball is in the member states' court

An EU directive is binding on the member states as far as the result to be achieved is concerned. This will mean, in other words, that, once the European Parliament and the European Council have adopted the proposal, all member states will need to adapt their national legislation to the directive. In other words, once adoption is a fact, the ball will be back in the member states' court. The draft directive then will give the member states time to amend national legislation until the proposed implementation date (i.e. 31 December 2014 as things are now) – which means they may also do so sooner.

The question then is, of course, what will happen if a member state fails to modify its national legislation in a timely manner. Although the clear directive provision has direct effect in such cases, it is actually not really conceivable that a taxpayer would want to invoke the non-implemented directive provision. The opposite scenario is not allowed: a member state cannot enforce its own omission of implementing the proposal vis-à-vis a taxpayer – which would furthermore conflict with the principle of legal certainty. The Commission is very likely to call to account any member states showing a clear lack of diligence in this respect, if necessary, by initiating the infringement procedure.

It should also be noted that, to the extent that the member states will be obliged to tackle, in an EU context, double non-taxation resulting from qualification differences with regard to financial instruments, this can also impact other situations of double non-taxation. This is because there are various rules (including the Code of Conduct rules, the State Aid rules and the non-discrimination provisions) that can force a member state to apply the provisions on double non-taxation more widely. An illustrative example is that the PSD provisions are in principle only relevant in an intra-EU but

cross-border parent-subsidiary situation. However, the PSD provisions can also affect situations of double non-taxation within a country's frontiers, for instance on the basis of the fact that no discrimination may arise between national and intra-EU situations.

Concrete consequence: need for reviewing intra-group financing in Europe

Ensuring long-term financing is a crucial requirement for international groups, all the more in light of the recent bank crisis. Intra-group financing is often centralised in a separate finance company, a kind of internal bank. A profit-participating loan used to be an attractive tool to fund the internal bank because it allowed groups to significantly reduce the risks associated with such finance function (e.g. by managing exchange rate risks) while ensuring sustainable and competitive taxation of the finance function.

The proposal of the European Commission could in certain cases increase the tax burden on the intra-group finance function, particularly where the finance centre uses hybrid instruments. Consequently, European groups will less often be inclined to use this financial instrument for funding the intra-group finance function and alternative funding structures may have to be considered. The importance of the impact of the proposal cannot be underestimated. Long-term financing is one of the crucial parameters for multinational groups to secure their competitive position and maintain their position in the market. It remains to be seen what the proposal outlined above will trigger in terms of the competitive position of certain countries which, over the years, have built a strong reputation in the area of intra-group finance operations. If such operations are carried out outside the EU, those groups can sometimes benefit from very attractive tax regimes. If those other regimes were left undisturbed in the framework of the BEPS or other initiatives, the proposed adaptation of the Parent-Subsidiary Directive could entail a competitive handicap. Needless to say, should such scenario materialise, the proposal would defeat its own purpose.

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