The EU draft anti-avoidance directive (ATAD)
A focus on CFC rules from a Swiss perspective

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The Anti Tax Avoidance Package of 28 January 2016

The Anti Tax Avoidance Package of 28 January 2016

Source: EU Commission,
http://ec.europa.eu/taxation_customs/taxation/company_tax/anti_tax_avoidance/index_fr.htm

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The draft ATAD

- **Background (explanatory memorandum)**

- Objective is to transpose the OECD BEPS measures into Member States' national systems in a coherent and coordinated fashion **in order to avoid fragmentation of the Single Market**

- The envisaged measures should not go beyond ensuring the minimum necessary level of protection for the internal market. The Directive should not therefore prescribe full harmonisation but **only a minimum protection for Member States' corporate tax systems**

The Draft ATAD

Measures against tax avoidance

Interest limitation rule (art.4)

Exit taxation (art. 5)

Switch-over clause (art.6)

General anti-abuse rule (art. 7)

CFC rules (art. 8-9)

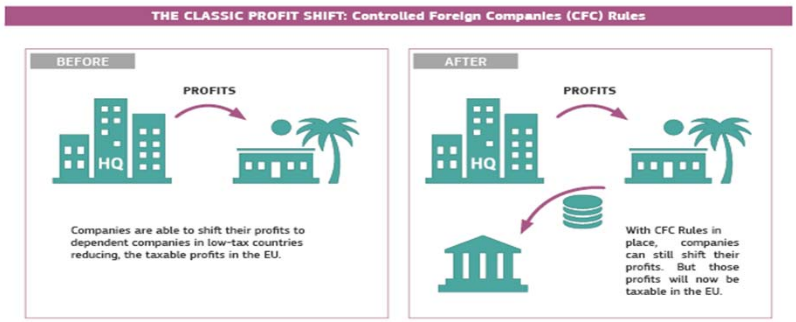
Hybrid mismatches (art. 10)

Art. 3 (minimum level of protection)

"This Directive shall not preclude the application of domestic or agreement-based provisions aimed at safeguarding a higher level of protection for domestic corporate tax bases"

The draft ATAD – Proposed CFC provisions (art. 8-9)

➢ **Objectives pursued by the proposed CFC provisions**



Source: EU Commission,
http://ec.europa.eu/taxation_customs/taxation/company_tax/anti_tax_avoidance/index_fr.htm

The draft ATAD – Proposed CFC provisions (art. 8-9)

➢ **Core principles of 28 January draft**

- Direct or indirect participation of more than 50%
- CFC income
- Effective tax rate in the jurisdiction of the CFC is lower than 40% than the one that would have been charged under the applicable corporate tax system in the Member State of the taxpayer
- **Distinction between third countries and Member States/EEA States.** In line **with CJUE case law**, provision would not apply to **Member States/EEA States** *"unless the establishment of the entity is wholly artificial or to the extent that the entity engages, in the course of its activity, in non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage ».*

The draft ATAD – Proposed CFC provisions (art. 8-9)

➢ **Are the proposed provisions in line with the BEPS core principles and action 3 recommendations ?**

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The draft ATAD – Proposed CFC provisions (art. 8-9)

➢**Policy objectives of CFC rules – *pro memoria***

•Conceptually, the design of CFC rules may pursue two different objectives which may influence their design:

1.Anti-deferral mechanism designed to enforce worldwide taxation in selected instances.

1.Anti-passive income mechanism where the nexus of such income with the State of residence of the subsidiary is too weak.

•As a matter of national policy, **capital-export neutrality/credit States (CEN)** would generally endorse objectives 1 and 2. **For capital-import neutrality/exemption States (CIN)**, on the other hand, the only policy justification for introducing a CFC rule may in our view be i.e. switch to CEN in the case of highly mobile capital with insufficient nexus in the State of the subsidiary.

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The draft ATAD – Proposed CFC provisions (art. 8-9)

➢In our view, draft ATAD proposed CFC provisions are not appropriate for the following reasons:

•With respect to third countries draft provision amounts to anti-deferral mechanism. Proposed provision thus (i) **goes beyond BEPS action item 3 recommendations,** (ii) may not be regarded as a "minimum framework", (iii) **excessively interferes with domestic tax policies of Member States**. Problematic proposal in light **of proportionality and subsidiary principles**

•Prevents the creation of a level playing field and leads to differentiated application of CFC rules contrary to the recommendations relating to BEPS action item 3 (see BEPS action 3 report, p. 17)

Compatibility with the EU-Swiss 1972 Free Trade Agreement ?

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EU-Swiss 1972 Free Trade Agreement

➢**Background – EU perspective**

•Article 23(1)(iii) FTA : *"(…)are incompatible with the proper functioning of the [FTA] in so far as they may affect trade between the [EU] and Switzerland: […] any public aid which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods"*

•Text of art. 23(1)(iii) (almost) identical to art. 107(1) TFEU. **However not equivalent to art. 107(3) TFEU**

- Unilateral declaration: Article 23(1)(iii) FTA to be applied in line with art. 107 et seq. TFEU

EU-Swiss 1972 Free Trade Agreement

➢ **Swiss-EU dispute**

- Article 23(1)(iii) FTA invoked by the EU in February 2007 to categorize Swiss privileged regimes as unlawful state aid. Approach and reasoning followed by the Commission in line with practice and case law relating **to the derogation test.**

- Switzerland disputed the application of the FTA in the field of corporate direct taxation

- Controversy was finally resolved in 2014 on the basis of the principles governing harmful tax competition with Swiss regimes currently being abolished

EU-Swiss 1972 Free Trade Agreement

➢**Consistent application of FTA by the EU**

•FTA should be applied consistently by the EU. Accordingly, the EU may not adopt rules violating the FTA, in particular art. 23(1)(iii).

•Especially at a time at which the EU advocates in favor of including state aid provisions in bilateral agreements: *« State aid provisions in bilateral agreements (…)* ***would create fairer competition between Member States and third countries in the area of business taxation****. The Commission will therefore work to include state aid provisions in negotiating proposals for agreements with third countries, with a view to ensuring fair tax competition with its international partners » (see external strategy).*

EU-Swiss 1972 Free Trade Agreement

- ➢ **Does a distinction between Switzerland (third country) and EU Member States in the area of CFC rules amount to a selective advantage under art. 23(1)(iii) FTA ?**

- ➢ **Two main issues**

- Reference framework and existence of a derogation

- Selective advantage

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EU-Swiss 1972 Free Trade Agreement

➢ **Reference framework**

•The reference framework is the general corporate tax system which is characterized by the (i) **"separate entity approach"** and, in a cross-border context, (ii) **the principle of territoriality applies.** As a result profits of a (domestic or foreign) sub are not consolidated with those of the parent company i.e. deferral is tolerated.

•Derogation should be tested in **light of the objective of the tax system**.

•Strict CFC rules, as those proposed by the draft ATAD, represent **a derogation to the reference framework i.e.** tax base of parent company is **exceptionally widened** to include certain items of foreign source income.

EU-Swiss 1972 Free Trade Agreement

➢ **Selectivity**

- A CFC rule distinguishing between EU subs (no application of CFC rules) and Swiss subs (application of CFC rule) provides, in our view, **a selective advantage to EU parent companies having EU subsidiaries as opposed to those having Swiss subsidiaries.**

- The advantage is in our view selective because **the exclusion from the general tax system is targeted at an individualised group of taxpayers.**

Final conclusions and policy considerations

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