BEPS and the EU

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Outline

1. Background
2. Examples
3. Implementation
4. Broader questions

1. Background

- **BEPS from EU perspective**
  - General political support & institutional involvement
    - One major conceptual disagreement (CCCTB)
  - Awaiting Commission's *Action Plan on Corporate Taxation*
    - "…ideas for integrating new OECD/G20 actions to combat base erosion and profit shifting (BEPS) at EU level"
    - Potential EU law constraints?
- **EU Law issues from BEPS perspective**
  - Increasing attention:
    - Started off with little discussion (eg HTC – A 5)
    - Increasing attention (eg CFC – A 3)

2. Examples

1. Address the tax challenges of the digital economy	9. Assure that transfer pricing outcomes are in line with value creation: risks and capital
2. Neutralise the effects of hybrid mismatch arrangements	10. Assure that transfer pricing outcomes are in line with value creation: other high-risk transactions
3. Strengthen CFC rules	11. Establish methodologies to collect and analyse data on BEPS and the actions to address it
4. Limit base erosion via interest deductions and other financial payments	12. Require taxpayers to disclose their aggressive tax planning arrangements
5 – Counter harmful tax practices more effectively, taking into account transparency and substance	13. Re-examine transfer pricing documentation
6. Prevent treaty abuse	14. Make dispute resolution mechanisms more effective
7. Prevent the artificial avoidance of PE status	15. Develop a multilateral instrument
8. Assure that transfer pricing outcomes are in line with value creation: intangibles	

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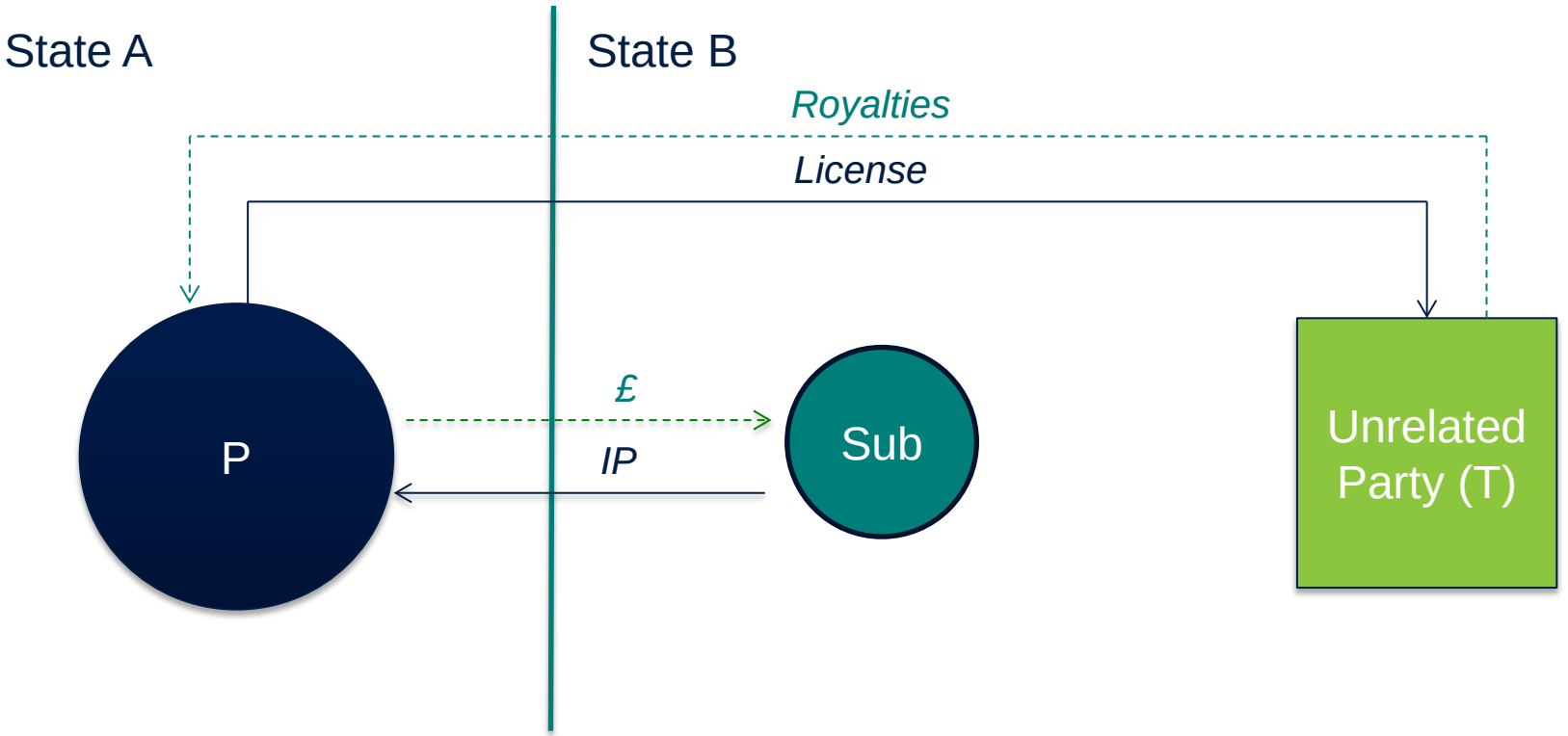
2a. Harmful Tax Practices (A 5)

- Sept 2014 Deliverable introduced substantial activity (SA) test – focused on IP regimes
- Most countries supported “modified nexus” approach (contra: UK, NL, ESP, LUX)
- “The purpose of the nexus approach is to grant benefits only to income that arises from IP where the actual R&D activity was undertaken by the taxpayer itself.”
- The proportion of income that may benefit from IP regime is the same proportion as that between qualifying and overall expenditures to create IP

$$\frac{\textit{Qualifying expenditures incurred to develop IP asset}}{\textit{Overall expenditures incurred to develop IP asset}} \times \textit{Overall income from IP asset} = \textit{Income receiving tax benefits}$$

  - QE: expenditures incurred by the company holding the IP
  - Not QE:
    - outsourcing to related parties or
    - Acquisitions

Modified Nexus Approach



P acquires partially developed IP from Sub for £40

P spends £60 on further developing the IP

Only 60% of the royalties received by P from T can be taxed at the IP box rate

2a. Harmful Tax Practices (A 5)

- UK-Germany Compromise
  - November 2014 UK-Germany compromise via joint statement
  - “Modified Modified Nexus Approach”
    - Uplift of QE: related party outsourcing or acquisition costs = 30% uplift
    - PB closed to new entrants by 30 June 2016
    - Grandfathering rules: abolished by 30 June 2021
  - Endorsed by all OECD and G20 countries
  - Endorsed by EU Code of Conduct on Business Taxation Group

2a. Harmful Tax Practices (A 5)

- *But is it compatible with EU Law?*
  - EU Code of Conduct on Business Taxation Group (Dec. 2014):
    - "[A]lthough it could be said that the modified nexus approach did not treat comparable situations in a discriminatory manner, **this of course did not preclude the possibility of a particular national measure being found incompatible with the Treaty freedoms in the future** because of a restriction to the right of companies to choose where they carry out their R&D activities. This would depend on the legal and factual context of the case."
  - HM Treasury (Oct. 2014):
    - '[W]e have **serious concerns about the nexus approach's compatibility with EU law**. The restrictions on eligible expenditure could influence the location of business activities within the EU and therefore infringe the freedom of establishment"
    - Do the modifications make a difference?

2a. Harmful Tax Practices (A 5)

- EU Code of Conduct Group and MSs do not have final say – CJEU does
- *So, is it compatible with EU Law?* NB Case law is very far from clear!
- Simplified evaluative process
  - Is there a restriction to the free movement?
  - Can this restriction be justified?
  - Is it proportionate?
- Different applications of MNA must be considered against these Qs
  - Eg Denial of full patent box treatment if IP acquired from foreign sub

2a. Harmful Tax Practices (A 5)

- Is there a restriction? Arguably yes
- Justifications? Unlikely
  - *Promotion of R&D by MS* – no: contradicts the objectives of the EU policy on research and technological development, Article 179 TFEU (rejected in Case C-39/04 *Laboratoires Fournier*).
  - *Tax avoidance* – no: wholly artificial arrangements test not satisfied
  - *Balanced allocation of taxing rights* – unlikely: accepted in various contexts to prevent shifting of tax base between jurisdictions but unlikely to be accepted in this context
- Proportionality: improved with uplift but still questionable
- ***Conclusion: unclear if this /other applications of MNA are compatible with EU Law***

2b. CFC (A 3)

- Discussion Draft published April 2015
- DD defines several “building blocks” necessary for effective CFC rules:
  - (i) Definition of a CFC, (ii) Threshold requirements, (iii) Definition of control, (iv) Definition of CFC income, (v) Rules for computing income, (vi) Rules for attributing income, and (vii) Rules to prevent or eliminate double taxation
  - Most BB= concrete rec. (eg threshold requirements)
  - Def of CFC income = no consensus, so includes several possible options

2b. CFC (A 3)

- DD: acknowledges EU Law constraint: *Cadbury Schweppes* – CFC ltd to *"wholly artificial arrangements"*
- DD makes 4 suggestions:
  - **Suggestion 1**: ***include "substance analysis"*** – only subject taxpayers to CFC rules if CFCs did not engage in genuine economic activities (*CS*)
    - Entails narrow CFC
    - No purely mechanical rules
  - **Suggestion 2**: ***extending CFC rules to domestic subs***
    - Adopted by Denmark (2007)
    - No consensus (eg Schoen and Rust pro, Maisto, Pistone and Schmidt – contra)
    - Criticized by Commission in 2007:
      - '[I]t would be regrettable if, in order to avoid the charge of discrimination, MSs extended the application of anti-abuse measures designed to curb cross-border tax avoidance to purely domestic situations where no possible risk of abuse exists. Such unilateral solutions only undermine the competitiveness of the MSs' economies, and are not in the interest of the Internal Market […] Moreover, it remains debatable whether such extension can successfully bring all restrictive measures into line with MSs's EC Treaty obligations'

2b. CFC (A 3)

- **Suggestion 3-4: *designing CFC rules on assumption that CJEU would be willing to accept wider CFC rules than allowed in Cadbury Schweppes***
  - CFC rules that target transactions that are 'partly or wholly artificial' (*Thin Cap*)
    - Based on controversial interpretation of *Thin Cap*
  - CFC rules to ensure a balanced allocation of taxing rights
    - Based on two cases*: SGI* and *Oy AA*, which concerned different factual context
    - Ignores potentially contradicting examples
    - Even if CJEU were to accept wider justifications, proportionality test to be satisfied
- ***Conclusion: Suggestion 1 seems safest, but is it desirable at the global level?***

3. Implementation

- Commission's *Action Plan on Corporate Taxation*

A. Harmonized areas

- Change to existing EU Directives
  - Change to Parent/Subsidiary Directive (A 2)
  - Change to Directive on Administrative Cooperation in the Field of Tax (A 5)

B. Non-Harmonised Areas

1. Coordinated

i. Hard Law: Directive(s)

- Unanimous agreement (TFEU art. 115)
- Enhanced Cooperation (TEU art. 20) (but note FTT experience)
- Homogeneity
- Safest route?
- Challengeable on grounds of non-compliance with EU Law – likelihood of success low (but still possible)

3. Implementation

ii. Soft Law

- Recommendations of Commission
  - Just a suggestion for MS
  - Not used very often
  - E.g. Recommendation on Aggressive Tax Planning 2012
    - Not very successful but this is a different context

- Resolutions of the Council of Ministers
  - Not very common
  - E.g. Resolutions on coordination of the Controlled Foreign Corporation (CFC) and thin capitalisation rules within the European Union 2012
    - Not very successful
  - E.g. Code of Conduct on Business Taxation on Harmful Taxation
    - More successful
- More homogeneity?
- Safer than uncoordinated?

3. Implementation

2. Uncoordinated

- Dangers:
  - Differences in implementation by MS
    - Preferences
    - Differences in interpretation of constraints
  - Less safe from challenge? Increased uncertainty?

4. Broader Questions

- Ultimately CJEU will decide on compatibility
- Will / should CJEU modify case law to accommodate BEPS proposals?
  - Implied in DD on A 3
  - Support from some academics
  - Support from Commission? Awaiting signals in its forthcoming report
  - Nudge: EU hard or soft law
- What if it did?
  - Law does evolve and courts do develop their jurisprudence over time
- CJEU could:
    - Alter justifications for restricting freedoms? (eg “artificial” not “wholly artificial”)
    - Introduce new justifications? (eg “necessary to defeat BEPS?”)

4. Broader Questions

- By altering justifications for restrictions, breadth of freedoms altered
- In turn this alters meaning of the internal market
- Questions then arise:
  - Conceptual
    - Is this change desirable or desired?
  - Practical
    - What are consequences on other areas of EU tax law (which have nothing to do with BEPS)
    - What are consequences on other areas of EU Law?
    - Will it open door for protectionist measures by states?
- Require careful consideration