

EUROPEAN COMMISSION
DIRECTORATE-GENERAL TAXATION AND CUSTOMS UNION
Analyses and tax policies
CCCTB Task Force

Brussels, 26 March 2008
Taxud TF1/RP

CCCTB/WP065\doc\en
Orig. EN

**COMMON CONSOLIDATED CORPORATE TAX BASE
WORKING GROUP (CCCTB WG)**

Anti-abuse rules

Meeting to be held on 14 and 15 April 2008

Centre de Conférences Albert Borschette
Rue Froissart 36 - 1040 Brussels

WORKING DOCUMENT

I. Introduction and purpose of the paper

1. On various occasions the discussions in the CCCTB WG have touched upon possible anti-abuse rules and experts have expressed themselves in favour of introducing such rules in the CCCTB, but the issue has not yet been treated in a systematic manner. For this reason the Commission Services committed itself to table a document on anti-abuse in which these rules are analysed in a comprehensive way.
2. The European Commission has recently issued a Communication on "The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries"¹. Any possible rule on anti-abuse in the CCCTB legislation should be compatible with the EC Treaty requirements. The Communication "analyses the principles flowing from the relevant ECJ case law with a view to prompting a more general debate on appropriate responses to the challenges faced by MSs in this area"². It provides a useful framework for the concrete rules of the CCCTB but obviously the CCCTB legislation needs to be more specific and detailed than the Communication.
3. As a general rule CCCTB taxpayers should be free to arrange their economic affairs in the manner they deem most beneficial for them. Nevertheless, tax planning may reach a point beyond which it cannot be tolerated by the tax authorities.
4. Anti-abuse rules cover a wide range of possible rules and provisions. Some MS apply a general anti-abuse rule open to be applied in any possible case of abuse, while others apply specific anti-abuse rules to combat a specific practice such as the thin capitalization rules, the Controlled Foreign Corporation (CFC) rules or the switch over rules from exemption to credit in certain situations. Most MS have a combination of general and specific anti-abuse rules.
5. In recent years the ECJ has made a number of important judgements in this area and several MS have been obliged to review their systems. The changes have been made in two ways: several MS have restricted the application of these rules only to residents in third countries; other MS have extended the application of these rules to cover also purely domestic situations. In this sense it should be noted that "in the Commission's view it 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"³.

II General Anti-abuse Rule

6. A general anti-abuse rule could be established in the CCCTB to allow tax authorities to re-characterise wholly artificial transactions. However, the taxpayer should always be able to refute this by producing evidence of a commercial justification.
7. The general anti-abuse rule could be established in combination with specific anti-abuse rules or without any other anti-abuse provision. There are pros and cons to these

¹ COM (2007) 785, Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee on "The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries"

² COM (2007) 785

³ COM (2007) 785

possibilities.

8. Establishing only a general anti-abuse rule would provide MS with a flexible tool to combat abusive practices, but at the same time it may be a difficult provision to apply, it could be understood differently in different MS, and it could therefore introduce uncertainty.
9. If the general anti-abuse rule is established in combination with other more specific anti-abuse provisions (thin capitalization, switch over, CFC...) the immediate question is what the scope of this general anti-abuse rule is. In the Commission Services view a combination would provide the tax administrations with easily and straight forward specific rules to combat specific and well known cases of abuse and a general rule could be applied to combat possible abuse that was not foreseen when designing the common rules.

III Specific anti-abuse provisions⁴

10. Instead of or in addition to the general anti-abuse rule, several specific anti-abuse provisions could be established: (i) thin capitalisation rules or more general rules to limit the deductibility of interest, (ii) switch over rules from the exemption to the credit method, (iii) CFC rules, (iv) rules to re-characterise the sale of shares as sale of assets to avoid the abuse of the consolidation rules in connection with the participation exemption⁵, (v) rules to avoid the possible double deductions (double dips) in the 'sandwich' situations⁶, (vi) possible rules to avoid the manipulation of the factors in the Formulary Apportionment.
11. This document will analyse how the aforementioned anti-abuse rules could be designed although there may be other possible specific anti-abuse rules to be considered.

1. Rules aimed at limiting the deductibility of interest

12. Traditional thin capitalisation rules were designed to avoid the taxpayers borrowing (in excess) money from a related party abroad. With this type of transaction the taxpayer is going to deduct the payment of interest and the recipient will not be taxed in the same jurisdiction. These rules established in the EU were usually applicable only for debt with residents in the EU and in third countries (not domestically).
13. Additionally, another objective has been added to the thin capitalisation rules: the rules are now sometimes designed not only to restrict excessive cross-border borrowing from related parties, and hence interest deductions, as described above, but also to determine if the amount of interest paid by a company is excessive (not only to their related parties but to all creditors of the company) – ie extending the restriction of interest deductibility to include interest on loans from third parties.
14. This phenomenon is illustrated by the rules recently introduced by several MS⁷ that limit the deductibility of interest to a certain threshold of the earnings before interest and taxes (EBIT) or of the earnings before interest, taxes, depreciation and

⁴ Some of the specific rules analysed in these part of the document may not necessarily be characterised as anti-abuse rules by all the MS.

⁵ CCCTBWP057, Section V.3. Sale of assets or shares

⁶ CCCTBWP057, Paragraph 87

⁷ For example these rules have been introduced by Denmark, Germany, France and Italy.

amortization (EBITDA). The justification for these rules is not found in tax principles. MS have considered that it is necessary to introduce these rules to protect the domestic tax revenues because they have observed that their companies have too high debt financing that they believe, presumably, is done mainly for reasons of tax optimization.

15. When designing how the interest limitation rules should work in the CCCTB various possibilities can be analysed:
16. A) EBIT or EBITDA tests: the EBIT or EBITDA tests introduced by MS usually allow companies to deduct a certain amount of interest that is determined as follows:
 - I. Companies are permitted to deduct interest expense to the extent of their taxable interest income and the excess amount of interest expense can only be deducted up to an amount equal to a certain threshold of EBIT or EBITDA.
 - II. The excess of interest expense that is not deductible during the tax period may be deductible in the following periods with the same limit of the established threshold of EBIT or EBITDA (carry forward of non-deductible interest expense).
 - III. Usually MS have designed certain rules entitled to limit the application of these rules in certain situations: for example a de minimis threshold, and/or a comparison with the equity percentage of the group.
17. B) Limitation of the interest deductible according to a fixed debt to equity ratio: when the debt to equity ratio is higher than a certain amount, the interest paid corresponding to the excess of debt may either be non deductible or be re-characterized as dividends.
18. C) Limitation of the interest deductible according to an arm's length basis: the limitation of the amount of interest paid to be deductible may be done looking at: (i) the amount of interest that would have been paid according to an arm's length basis and (ii) it can also be checked the amount of debt that would have existed according to the borrowing capacity of the taxpayer (arm's length).
19. The CCCTB rules could provide for either one of the previous possibilities (A, B, or C) or a combination of them. From discussions and comments received from MS the arm's length approach (C) appears to be less preferable than the other two (A and B) both of which would lead to a more certain result. In addition the recent trend in MS legislation seems to be favourable to introducing EBIT or EBITDA tests.
20. It is the Commission Services view that the preferable option could be the EBIT or EBITDA test (option A) as it is simpler to apply and is in line with the view that the traditional thin capitalisation rules have not been sufficient to protect the domestic tax revenues from excessive debt financing considered to be carried out mainly for reasons of tax optimization.
21. If the EBIT or EBITDA tests were to be introduced in the CCCTB the limit should be applied for the whole consolidated group where the intra-group payments of interest inside the group are eliminated.

22. When designing these rules for the CCCTB several aspects should be defined:

- I. Either EBIT or EBITDA should be selected and defined.
- II. Establishment of the threshold: the thresholds that have been established by MS are around 80% if EBIT is chosen or around 25-30% if EBITDA is applied.
- III. Definition of interest income and interest expense.
- IV. Decide whether the excess of interest expenses may be carried forward over an unlimited period of time or only for a limited number of years.
- V. Establishment of a de minimis rule.
- VI. It would probably be desirable to design an escape rule that allows that in certain cases the interest is deductible because the amount of interest paid is 'normal'. (One of the criticisms of the EBIT or EBITDA methods is that although it provides certainty it can also be manifestly unfair in certain circumstances).

One possibility could be to allow taxpayers to compare the equity percentage of the consolidated group (where there is a group) to that of the group worldwide to prove that the debt is not excessive. The application of this rule could be questionable where the consolidated CCCTB group is the same as the worldwide group. Here the comparison of the two equity percentages would be the same with the consequence that the CCCTB group would automatically be excluded from any limitation calculated under EBIT/EBITDA, ie the escape clause test would always be satisfied. This makes sense if all controlled subsidiaries of a parent company are included in the consolidated group - all intra-group loans would be eliminated and all other loans would have to fulfil the arm's length requirement. For loans to and from major shareholders special rules such as rules for 'closely held' companies could be applied. Control for the purposes of this test would have to be defined differently from the test for consolidation. For example it could be defined in accordance with IAS 27 or in a more simplified way as more than 50% of voting rights or capital ownership. (Otherwise a company controlled by say 51% would not be consolidated and would therefore count as a third party for the purposes of the debt equity calculation).

Another option could be to apply a two stage test. First, the EBIT or EBIT(DA) test and second, only in those cases that the company does not pass the test to apply a fixed equity to debt ratio (a combination of the tests described in A and B).

23. If an EBIT or EBITDA rules are not introduced it seems desirable to introduce as a minimum a rule limiting the deductible amount of interest according to a fixed equity to debt ratio to be applied to interest paid to a related non-resident company.

2. Switch over rule

24. In CCCTB/WP/057 the Commission Services suggested that "as regards third country income, dividends received from major shareholdings and PEs would be exempt subject to a switch over to the credit method where the corporate tax rate in the source country was low"⁸.
25. The document explains how the switch over mechanism should work. It is still the Commission Services view that the switch over rule should be applied as described in CCCTB/WP/057.

3. CFC rules

26. According to the Communication "the main purpose of CFC rules is to prevent resident companies from avoiding domestic tax by diverting income to subsidiaries in low tax countries, and – as the ECJ has recognised – CFC rules are in general apt to achieve that purpose."⁹
27. Many MS have CFC rules in their national legislation that usually try to combat those cases when passive income is diverted through a foreign company controlled by the resident company and located in a low tax rate country. The consequence of the application of the CFC rules is that the undistributed income of the CFC will be included in the tax base of the resident shareholders.
28. In CCCTB/WP/057 the Commission Services asked the MS if, when designing the rules to protect the tax base, CFC rules were necessary or if it was enough with a switch over to credit where exemption is not justified because of the low local taxation on the profits. In general, experts considered that CFC rules should be applied in addition to the switch over rules as CFC rules apply not only to distributed dividends but also to undistributed income of the CFC.
29. When designing the CFC rules in the CCCTB one of the fundamental issues is the determination of the scope of these rules: if CFC rules were to be introduced in the CCCTB they should be in line with the recent ECJ rulings. To comply with the ECJ law either CFC rules are only to be applied in relation with third countries or CFC rules are also to be applied within the EU but, in this case, the rules should be targeted at wholly artificial arrangements only¹⁰.
30. When designing the CFC rules to be applied in relation with third countries several aspects need to be determined:
- Definition of control: the CFC rules must apply to foreign corporations that are controlled by residents. There are different options to define control, probably for the CCCTB the CFC should be considered to be under the control of the resident company if this company controls, direct or indirectly, more than 50% of the voting rights, ownership or capital or entitlement to profits, but other possibilities can be examined: (i) same rules as to define the related parties (according to CCCTB/WP/057 - 20% of voting rights¹¹), (ii)

⁸ CCCTBWP057, Paragraph 120

⁹ COM (2007) 785

¹⁰ COM (2007) 785

¹¹ CCCTBWP057, Paragraph 78

control as defined in the parent Subsidiary Directive (10% of ownership of capital). It would probably be desirable to include those situations when the 50%+ threshold is owned by any entities acting 'in concert'.

- The foreign tax rate considered to be too low should be determined. The determination of the rate should probably be consistent with the switch over rules: a rate of not less than 40% of the average statutory corporate tax rate applicable in MS and not being subject to a special regime resulting in a substantially lower level of taxation¹².
 - CFC should be defined, either taking into account that the CFC does not have a real economic activity or considering the nature of the income earned by the CFC, and checking if it is mainly passive income.
 - Once the CFC is identified the income integrated in the tax base of the resident company can either be (i) only passive income, or (ii) all the income of the CFC.
31. As already mentioned the consequences of the regime will be that the undistributed income of the CFC will be included in the tax base of the resident shareholders. The income should be calculated according to the CCCTB rules and should be included in the tax year that comprises the day of the last day of the CFC tax period.
32. The application of the CFC regime should not lead to higher taxation (than in a domestic situation) and should avoid any double taxation: the same income can only be included once in the taxable base, regardless of the way it is included. For this reason, there should be relief for the taxes paid abroad and the income that has been taxed in the CFC by being included in the tax base of the resident shareholders should not be double taxed when the dividends are distributed to those shareholders. There are two possible ways of avoiding this double taxation:
- If only the undistributed passive income is included in the tax base of the resident shareholder when taxing the dividends paid by the CFC (that will not be exempt because of the switch over mechanism) it will be necessary to distinguish between the dividends that come from the passive income that has already been taxed and those that are a distribution of the active income not yet included in the tax base of the shareholder. An alternative could be to assume that the dividends are firstly paid out of the passive income.
 - On the contrary, if all the income of the CFC is included in the tax base of the resident shareholder the dividends distributed should not be taxed again.
33. To calculate the income generated by the sale of the shares in the CFC it is also necessary to deduct the retained earnings already included in the base of the shareholder.
34. It is the Commission Services view that the CFC should be defined considering the nature of the income earned by the company: if a certain threshold of the total income earned by the company is passive income (for example 80%) the company would be a CFC. Once the CFC is identified only the passive income should be integrated in the tax base of the resident company and when the CFC distributes dividends it would be

¹² CCCTBWP057 Paragraph 128

assumed that the dividends are firstly paid out of the passive income. Management costs relating to the holding from which the exempt distribution of profits is derived should be non-deductible expenses¹³.

4. Rules to recharacterise the sales of shares as sales of assets to avoid the abuse of the consolidation rules in connection with the participation exemption

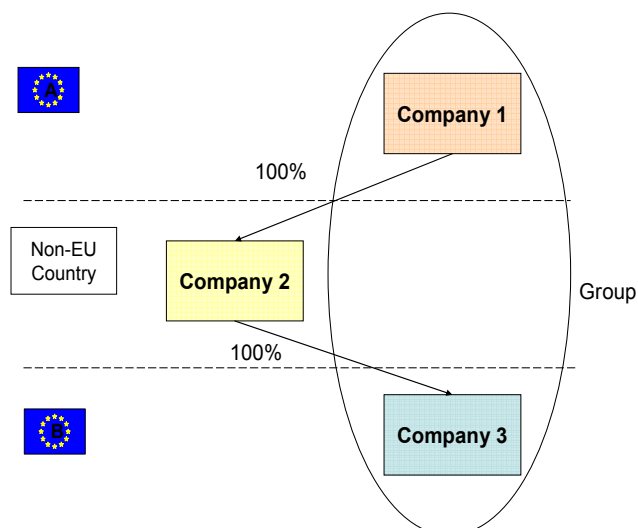
35. During the CCCTB meetings there was some concern that inside a consolidated group assets could be located in one of the companies of the group (without the intra-group transaction being taxed) and the shares in this company could then sold without being taxed because of the participation exemption.
36. The problem was addressed in the CCCTB/WP/057 that proposes the following rule: "gains realized on the disposal of such shares would not be exempted to the extent that assets were transferred to the departing company within the present or previous tax year and their disposal would have triggered a gain (possibly with the proviso that it is open to a taxpayer to demonstrate valid commercial reasons)"¹⁴.
37. The above mentioned rule should probably be extended to those cases where a company leaves the group (or the group terminates) but without a sale of shares, (e.g. the group does not renew the option after the initial 5 years period) in this case there could also be immediate taxation of the unrealized capital gains on assets that were transferred to the departing company within the present or previous tax year and their disposal would have triggered a gain.
38. If such a rule should be symmetric consideration needs to be given to how to apply it to those cases when the intra-group sale of assets would have generated a loss.
39. Some MS have said the period of two years foreseen in the document is too low and therefore the rule is too easy to manipulate.

5. Rules to avoid the possible double deductions in the 'sandwich' situations.

40. During the meetings of the CCCTB WG and in the meetings of the SG5 experts considered that in the so called 'sandwich' situation there is a possible danger of double deduction that may require an anti-abuse rule. We have therefore considered this in some detail below.
41. The 'sandwich' situation is described in CCCTB/WP/057 paragraph 87 when it says that: "The fact that the ownership chain of a group of EU companies includes a non-EU link company (the so called 'sandwich' situation) does not break the chain; otherwise taxpayers could split groups into multiple groups".

¹³ CCCTBWP057, Paragraph 134

¹⁴ CCCTBWP057 Paragraph 109



42. In fact potential problems of double deductions arise both when the 'sandwich company' is in a non-EU country and when the sandwich company is in an EU MS but is excluded from the consolidated group because for example the ownership threshold for consolidation is not satisfied. Two different problems of double deduction may appear in this situation:

- If company 3 borrows money from company 2 that at the same time borrows this money from company 1 and company 3 has a liquidity problem and it is not able to repay the loan, company 2 may recognise a provision for a bad debt in accordance with the domestic rules of the Non-EU-Country. If company 2 then experiences the same problems in repaying the loan to company 1, company 1 will recognise a provision for the amount of the loan and, at the same time, will be able to consolidate the losses incurred in company 3. In this way Company 1 'benefits' from the losses in company 3, and also 'benefits' from a bad debt deduction due to its loan to company 2. This potential double deduction could be stopped by:
 - A general principle that no transaction should give rise to a double deduction within the CCCTB group – probably rather difficult to draft to ensure that it 'caught' all such transactions, and only such transactions.
 - Relying on a 'general' anti-avoidance clause – potentially difficult to apply in a uniform way.
 - A specific rule related to deductions for bad debts, denying deductions for bad debts with related parties.
- Additionally company 1's participation in company 2 represents the value of the non-EU entity and of all its subsidiaries. Consequently, all losses incurred by company 3 and its subsidiaries in the EU will have an effect on the value of the participation. Therefore company 1 could 'benefit' from losses made by company 3 by consolidating them, and subsequently 'benefit' from a loss on the sale of shares in company 2 which had lost value due to the losses. However, the CCCTB rules foresee a participation exemption for major

shareholders (more than 10% voting rights) so only losses on share sales where the holding was less than 10% would potentially create a loss. This opens the possibility of up to 10% of the losses being deducted twice; or in more extreme cases up to 25% of the losses being deducted twice where the share sale is not protected by the participation exemption because it is purchased and sold within 12 months¹⁵. This potential double deduction could be stopped by:

- The general principle mentioned above.
- The general anti-avoidance clause mentioned above.
- A specific rule – which could be complex to draft and might not be considered necessary given the likelihood of the circumstances occurring is rare.

43. There seem to be possible solutions to the questions raised concerning the 'sandwich' solutions. Indeed, it is arguable in the second example whether a genuine risk exists. However, these questions would seem to apply to existing domestic 'consolidation' systems and experts are invited to comment on how they have dealt with the questions, or why they have felt that they can be ignored.

6. Rules to avoid the manipulation of the factors in the Formulary Apportionment (FA)

44. MS have expressed their concern that the factors included in the FA can be manipulated to influence the distribution of the base among the different MS.

45. Of the three factors likely to be included in the FA, the factor assets is one that may be open to manipulation as the intra-group sales of assets will not be taxed. A possible rule could be introduced saying that the intra-group movements of assets are not taken into account if they are found to be made only with the intention of influencing the distribution of the base. Although most movements of assets would inevitably involve commercial considerations high value mobile assets such as aeroplanes used for transport could theoretically be based in a number of different states and transfers could be made solely for tax reasons. Another possibility would be to rely on the general anti-abuse clause.

IV. Questions for discussion

A) Do experts think that a general anti-abuse rule should be established?

B) How should a general anti-abuse clause relate to a specific anti-abuse provision? i.e if a transaction is tested against a specific anti-abuse rule and found not to be abusive can the same transaction be tested against the general anti-abuse rule?

C) Do experts agree on the introduction of a rule limiting the deductibility on interest to a certain threshold of EBIT or EBITDA as foreseen in paragraphs 15 to 17?

D) Do experts agree with the switch over rules from exemption to credit, as it is described in CCTB/WP/057?

¹⁵ CCTBWP057, Paragraph 125

E) Do experts agree that CFC rules should be established for controlled entities located in low tax countries outside the EU? Should the CCCTB rules establish the possibility of applying the CFC rules inside the EU limited to wholly artificial arrangements?

F) Do experts agree with the rules to re-characterise the sales of shares as sales of assets to avoid the abuse of the consolidation rules as foreseen in the CCCTB/WP/057?

G) Do experts consider that rules to avoid the possible double deductions in the 'sandwich' situations should be introduced?

H) Do experts consider that there is a need to design rules to avoid the manipulation of the factors in the Formulary Apportionment?

I) Do experts consider that other specific anti-abuse rules should be established?