EUROPEAN COMMISSION
DIRECTORATE-GENERAL TAXATION AND CUSTOMS UNION
Analyses and tax policies
Company Taxation Initiatives

Brussels, 30 August 2010
TaxudD1/

CCCTB/RD\004\doc\en
Orig. EN

WORKSHOP ON THE COMMON CONSOLIDATED CORPORATE TAX BASE (CCCTB)

Anti-Abuse Rules in the CCCTB

20th October 2010

Charlemagne

Rue de la Loi 170 - 1040 Brussels

ROOM DOCUMENT

Disclaimer

This paper has been prepared to facilitate discussion on possible rules to be included in a possible proposal for a CCCTB Directive. For convenience, use is often made of phrases such as "the rule will apply", "interest will be deductible where..." etc. It should however be noted that such wording is meant to represent only the latest technical expert views which may be subject to change and in no way pre-judges the contents of a possible future Commission proposal.

Anti-Abuse Rules in the CCCTB

Introduction

1. In 2007, the European Commission 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]. The Communication analyses the principles flowing from the relevant case law of the Court of Justice of the EU (ECJ) with a view to prompting a more general debate on the appropriate responses to the challenges faced by Member States in this area.

2. On 8 June 2010, the Economic and Financial Affairs Council adopted a Resolution on the coordination of the Controlled Foreign Corporation (CFC) and Thin Capitalisation rules within the European Union[2]. The Resolution, recalling the case law of the ECJ in the field of tax anti-abuse measures, recommends that Member States adopt certain common guiding principles when applying cross-border CFC and Thin Capitalisation rules within the EU (provided that the rules are also applicable in similar domestic situations).

3. The Commission Services expressed some initial thoughts on anti-abuse matters in a technical outline of the CCCTB issued in July 2007[3] for discussion at the CCCTB Working Group meetings on 27-28 September and 10-12 December 2007. A detailed analysis of alternative solutions for combating abusive tax practices followed in a working document which exclusively discussed anti-abuse rules and was submitted to the meeting of the CCCTB Working Group on 13 and 14 April 2008[4]. The rules under examination generally reflect the shape of most national schemes, in the sense that they are premised on a combination of general and specific anti-abuse provisions. The effectiveness of such a scheme will largely rely on the complementarities between those two types of rules.

4. The principles on tax anti-abuse rules set out in the Commission Communication of 2007 and the political commitments of the Council Resolution of 2010 offer a useful framework for the CCCTB. The current paper discusses how the Commission Services have taken the thinking of the 2008 working document on anti-abuse further and passed from an analysis of alternatives to specific policy choices for each targeted type of abuse.

5. The anti-abuse shield of the CCCTB is structured through rules at 2 levels:
   - **(i)** A General Anti-Avoidance Rule (**GAAR**);
   - **(ii)** **Specific rules** which have the function of protecting the consolidated tax base[5] from erosion in relations between the group and the outside world (e.g. Controlled Foreign Company (CFC) legislation, disallowance of foreign-source interest deduction and switch-over clause). Other provisions may be intra-group oriented

---

[1] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries, COM (2007) 785, 10.12.2007.

[2] Council Resolution, The coordination of the Controlled Foreign Corporation (CFC) and Thin Capitalisation rules within the European Union, 10597/2010, 08.06.2010.

[3] Commission Working Document, CCCTB: possible elements of a technical outline, CCCTB/WP/057/doc, 26 July 2007.

[4] Commission Working Document, CCCTB: Anti-Abuse Rules, CCCTB/WP/065/doc, 26 March 2008.

[5] If a taxpayer applies the CCCTB without consolidation, it will be subject to the same common anti-abuse rules for the purpose of protecting its (individual) tax base from erosion.

(e.g. 'sandwich case' which raises the risk of double deductions within the same group).

A. General Anti-Abuse Rule (GAAR)

6. The application of a GAAR is triggered when a transaction or series of transactions are carried out for the sole purpose of avoiding taxation. The rule targets practices without economic substance and implicitly aligns tax avoidance with the concept of 'purely artificial arrangements', as developed by the ECJ. The outcome of applying a GAAR is to **ignore** the steps (i.e. one or more transactions) which have been pronounced artificial.

7. The rule also contains an escape clause. A taxpayer having a choice between two or more possible transactions may legitimately opt for the operation that leads to a lower tax liability, insofar as the envisaged activity carries a commercial purpose. It follows that, to the extent that tax planning incorporates elements of a genuine conduct of trade, it is in principle allowed, regardless of whether a scheme is in essence designed to mitigate tax. A transaction or series of transactions is then ignored if the taxpayer fails to provide evidence of a commercial justification for its activity.

8. A CCCTB GAAR could be worded as follows:

Where a transaction or series of transactions are carried out for the sole purpose of avoiding taxation, they shall be ignored for the purposes of calculating the tax base. This provision shall not apply to genuine commercial activities where the taxpayer is able to choose between two or more possible transactions which have the same commercial result but which produce different taxable amounts.

What are your views of the GAAR?

B. Specific Anti-Abuse Rules

9. The following anti-abuse rules will apply in conjunction with the GAAR. Given that they target specifically identified problems, the GAAR should only be considered if a potentially abusive practice does not fall within the scope of any of the specific rules.

(i) Disallowance of third-country source interest deduction;
(ii) Switch-over from a tax exemption of foreign income to relief by credit;
(iii) Controlled Foreign Company (CFC) legislation;
(iv) Disallowance of the participation exemption in share disposals;
(v) Rules to tackle double deductions in the so-called 'sandwich cases';
(vi) Rules to avoid a manipulation of the asset factor.

(i) Disallowance of third-country source interest deduction

10. This provision is designed to achieve the effect of a Thin Capitalisation rule.

11. Interest paid to an associated enterprise[6] in a third-country will not be deductible where:
    - The statutory corporate tax rate in the third country is lower than 40% of the average statutory rate in the EU; or
    - A special regime which provides for a substantially lower level of taxation than the general regime is in place in the third country.

Further, an additional condition applying to both the above alternatives is the absence of an agreement providing for the exchange of information on request to a standard comparable to the Mutual Assistance Directive[7].

12. The rule has been designed to cover not only cases of definitive influence and control that naturally fall within the ambit of the freedom of establishment but also cross-border investment to which the free movement of capital is of application. Based on the wording of Article 63(1) of the Treaty on the Functioning of the European Union (TFEU), the free movement of capital incorporates an external dimension, meaning that it extends the non-discrimination/non-restriction principle to the commercial activity between Member States and third countries. The ECJ has interpreted this external dimension as meaning that the rights and obligations attached to the free movement of capital vis-à-vis third countries shall be contingent upon the existence of a framework for the exchange of information between the relevant parties. The CCCTB rules on the limitation of interest deduction have been construed to be in line with this jurisprudential precedent.

13. The CCCTB contains several references to the exchange of information in relations with third countries. The relevant provisions are normally contained in bilateral agreements and the relevant treaty to be examined will be the one in force between the countries where the CCCTB member company and the associated company directly involved in the flow of interest are resident.

Escape clause

14. By way of exception, such interest (i.e. paid to an associated company resident in a third low-tax country with which there is no agreement for the exchange of information on request) will still be deductible if:
    - The payer of the interest has included CFC income in its tax base. Interest will be deductible only up to the amount of that income. [This is to ensure that, where income in the associated enterprise has already been taxed, the interest deduction will not be disallowed as well];
    - The interest is paid to a company whose principal class of shares is regularly traded on one or more recognised stock exchanges; or
    - The payee is engaged in the active conduct of trade or business in its country of residence.

What are your views of the suggested rule on the limitation to interest deduction? Is it a sufficient replacement of Thin Capitalisation?

[6] For the definition of associated enterprises, see Room Document **CCCTB/RD\003\doc\en** on the 'Transactions and dealings between the group and entities outside the group'.

[7] Council Directive (EEC) 77/799 of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation [1977] OJ L336 (*hereinafter* Mutual Assistance Directive).

(ii) Switch-over from a tax exemption of foreign income to relief by credit;

15. The CCCTB rules provide for the tax exemption of profit distributions (i.e. both portfolio dividends and direct investment) and proceeds from share disposals flowing into the group as well as for income earned from a PE located in a third country. To protect the common tax base from erosion, the system accommodates a switch-over mechanism designed to act as a 'gatekeeper', which is meant to discourage the inflow of revenues through low-tax countries. This is achieved by making inflows of otherwise exempt third-country income subject to tax. In certain circumstances, relief by credit is given for tax which has already been paid in the country of source but this does not include credit for the underlying tax. If the distributed profit and/or the proceeds of a share disposal are linked to an entity which has already been taxed by the group as a CFC, the relevant amounts will effectively continue to benefit from the tax exemption in order to avoid double taxation (i.e. once as a CFC; once on a dividend distribution or disposal of shares).

16. Generally, the tax exemption switches over to credit if the income flowing into the group originates in a low-tax third country. This will be a jurisdiction that, under its general tax regime, operates a statutory corporate tax rate lower than 40% of the average statutory corporate tax rate in the Member States or a special regime allowing for a substantially lower level of taxation than its general regime.

Do you have any comments on a possible switch-over clause?

(iii) CFC Legislation

17. It is common that Member States have CFC rules in their national legislation to combat the artificial diversion of income to controlled foreign subsidiaries resident in low-tax territories. The common underlying principle pertaining to CFC schemes is the protection of the domestic tax base against erosion through practices of artificial income shifting. Beyond this common starting point, national schemes present some amount of diversity. For instance, there are systems which draw a distinction between active and passive income and subject only the latter to CFC rules. Further, even though the practical effect is always the same (i.e. non-distributed income of the CFC is taxable at the level of its resident shareholders), it can be that the method for arriving at this result differs. For instance, some Member States refer to piercing the CFC's corporate veil and others deem a notional dividend distribution.

18. CFC rules in the CCCTB function as an adjunct and not as an alternative to the switch-over clause. This implies that income, if already taxed under CFC rules, will have to be deducted from subsequent distributions of profit to avoid subjecting the same items of income to tax twice. Accordingly, if a taxpayer disposes of its participation in a CFC, the proceeds will be reduced by the non-distributed amounts which have already been included in the tax base and taxed as CFC income.

19. The **non-distributed income** of an entity qualifying as a CFC is subject to tax without any further distinction (e.g. between active and passive income) in proportion to a taxpayer's profit entitlement to the entity. CFC legislation applies where the following requirements are fulfilled:

(a) A taxpayer, by itself or together with its associated companies, holds more than **50% of the voting rights or** owns more than **50% of the capital or** is entitled to more than **50% of the profits** of an entity resident in a third country;

(b) The **third country is a low-tax jurisdiction**, meaning that, under its general tax regime, it operates a statutory corporate tax rate lower than 40% of the average statutory corporate tax rate in the Member States or a special regime allowing for a substantially lower level of taxation than the general regime;

(c) The entity's principal class of shares is **not** regularly **traded on one or more recognised stock exchanges**; and

(d) More than **30%** of the income accruing to the entity is **'tainted'**. The concept of 'tainted' income includes certain listed types of revenues (i.e. interest, royalties, dividends, income from the disposal of shares, income from insurance, banking and other financial activities, income from movable property or from immovable property, unless a DTC is in place and provides otherwise) where more than 50% of this category of income is derived from transactions between the CFC and the taxpayer or its associated enterprises.

20. CFC rules in the CCCTB only apply to subsidiaries resident in a third country. Given that CCCTB taxpayers are assumed to have a "definitive influence and control" over their third-country CFCs, the rules operate outside the scope of the fundamental freedoms since the freedom of establishment is only relevant within the EU. In the light of this, an escape clause grants a waiver to countries of the European Economic Area which exchange information on request to the standard of the Mutual Assistance Directive.

21. Loss-making CFCs will be entitled to carry forward their losses for future years.

What are your views of the suggested CFC rules?

(iv) Disallowance of the participation exemption in share disposals

22. Under the general rules of the CCCTB on participation exemption, disposals of shares resulting in a taxpayer leaving the group are carried out free of tax. This tax exemption is disallowed if the leaving taxpayer acquired, by an intra-group transaction, (individually depreciable) fixed assets during the current or previous tax year. Considering that the gain on sales of assets is taxable, the objective of this anti-abuse provision is to discourage practices of moving assets to a specific taxpayer, for the sole purpose of taking them out of the group through a tax-free disposal of shares.

23. The rule takes priority over the 'leaving rules' in business reorganisations, which delineate the fiscal treatment of fixed assets for the 3 years that follow their sale out of the group[8]. Specifically, if a disposal of shares leading a company to leave a CCCTB group is subject to a tax charge because assets were moved to the leaving company in the current or previous tax year, any subsequent sale of those assets will not generate a second tax liability under the CCCTB.

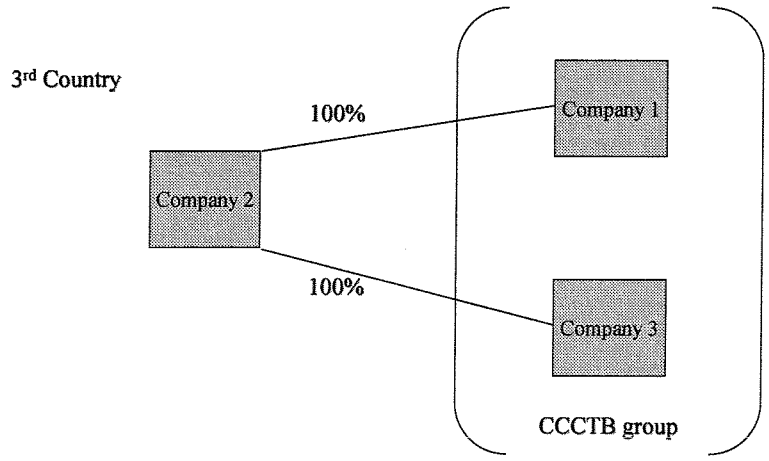
24. Taxpayers are given the opportunity to retain the participation exemption if they

[8] For the re-attribution of the proceeds from such sales to the consolidated tax base, see Room Document **CCCTB/RD\002\doc\en** on 'Business Reorganisations in the CCCTB'.

demonstrate that the intra-group transactions consisting of moving the assets to the leaving taxpayer were carried out for valid commercial reasons.

(v) Rules to tackle double deductions in the so-called 'sandwich cases'

The 'Sandwich' Case



25. The main problem attached to 'sandwich' cases is a risk of double deduction at the level of Company 1, which may take any of the following two forms:

(a) Company 1 benefits from a deduction of trading losses (incurred by consolidated Company 3) and makes provisions for bad debt.

When a loss-making Company 3, being in a liquidity problem, cannot meet its obligations under a loan vis-à-vis Company 2, the latter may recognise a provision for bad debt according to its national law. As a consequence, Company 2 may also experience problems in repaying its own loan to Company 1, in which case the latter will also recognise a provision for the amount of the loan. Further, Company 1 will also benefit from the consolidation of Company 3's losses since both companies are part of the same CCCTB group. This creates a setting of double deduction.

(b) Company 1 benefits from a deduction of trading losses (incurred by consolidated Company 3) and incurs a capital loss from the disposal of its shares in Company 2.

Losses at the level of Company 3 will normally affect the value of Company 1's participation in Company 2 (and its subsidiaries). It follows that, should Company 1 sell its shares in Company 2, it would most possibly incur a capital loss as its holding should be expected to have lost part of its value due to Company 3's trading losses. Under the CCCTB, there is no such risk of double deduction because the system operates a regime of tax exemption of disposals of shares irrespective of the size of holding.

26. To prevent double deductions in 'sandwich' cases, the CCCTB rules require that the third-

country company should be located in a jurisdiction which exchanges information on request to the standard of the Mutual Assistance Directive. Otherwise, the group structure will not be eligible for consolidation under the common rules.

(vi) Rules to avoid a manipulation of the asset factor

27. Acknowledging the risk of manipulating the asset factor, notably through tax-free intra-group transfers of assets, the CCCTB contains rules to prevent practices which are solely driven by tax considerations.

28. If an asset is sold outside the group following an intra-group transfer in the same or previous tax year, the asset is deemed to have always remained with the group member which held it prior to such intra-group transfer. Further, a taxpayer is always given the opportunity to prevent this adjustment if it successfully demonstrates that the intra-group transfer was made for genuine commercial reasons.

29. Intra-group transfers of assets having solely an object of tax avoidance can also be disregarded through the GAAR.

What are your views of the rules under (iv), (v) and (vi)?