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S K A T T E -
D E L E G A T I O N

Finansdepartementet

103 33 Stockholm

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The European Commission proposal for a Council Directive on Tax Avoidance practices COM (2016) 26 final

Opinion

Näringslivets skattedelegation (NSD) does not believe that a Directive will ensure an appropriate and a consistent implementation of the OECD's recommendations within the EU and urge the Swedish government to oppose the proposal. NSD does not agree that the minimum standard proposed by the Commission will solve the problem of fragmentation due to unilateral actions by Member States. On the contrary, by giving Member States the possibility to implement stricter rules, going beyond what is proposed by the OECD, the risk of fragmentation remains unconstrained.

The European economy will be at a competitive disadvantage if the Directive is adopted. An agreed statement at an ECOFIN meeting confirming that all Member States will revise their national tax systems to be consistent with the OECD's recommendations would be preferable and sufficient at this stage. If desired by Member States, the Commission could be given a role to review whether appropriate changes have been made in line with such a commitment. Uniform implementation globally of BEPS standard is key for the OECD/G20 project to be successful. However, the draft Directive is inconsistent with, and goes beyond the OECD recommendations. By deviating from the international agreements made at the OECD level, the EU will introduce double or multiple standards undermining the consistency of international taxation rules and principles.

The manner in which the Commission is trying to rush a comprehensive package of new repressive measures in a Directive, without a proper impact assessment and sufficient time for stakeholder and Member State input, is simply not acceptable.

Background

On January 28, 2016 the EU-Commission presented a proposal for a Directive containing measures to prevent tax avoidance and to improve the functioning of the internal market. The proposal includes measures regarding *(i)*, the deductibility of interest, *(ii)* exit taxes, *(iii)* a so-called switch-over clause *(iv)* a general anti-abuse rule (GAAR), *(v)* rules on Controlled Foreign Companies (CFC rules), and *(vi)* rules on hybrid mismatches.

The Commission states that the Directive is meant to ensure that Member States transpose the OECD BEPS recommendations into their national tax systems in a coherent and coordinated fashion.

Fundamental concerns

The proposal covers a broad range of detailed national tax matters. In addition, it goes beyond the OECD recommendations. It is stated that "the EU should encourage its international partners to also adopt these higher standards". However, the Directive would be in place irrespective of actions taken by other countries. The US in particular has expressed considerable reluctance to implement several of the action points in the OECD-BEPS proposal[1].

In order to avoid fragmentation due to unilateral uncoordinated action by Member States, the Commission argues that EU action in implementing the OECD BEPS recommendation is necessary. However, by giving Member States the possibility to implement stricter rules, going beyond what is proposed by the OECD, the risk of fragmentation remains unconstrained.

Based on the strong links to the OECD project, evidence supplied in the Staff Working Document and stakeholders' input at a previous stage, the Commission argues that an impact assessment is not necessary. The fact that some, but not all, of the provisions have been extracted from the original proposal for a Common Consolidated Corporate Tax Base (CCCTB) does not alter the fact that this proposal for a Directive constitutes a **new** legislative proposal and should be dealt with accordingly. In addition, the links to the OECD are not consistent in the draft Directive. The BEPS measures are aimed at ensuring that tax is levied in the country where the value and profit is created. This is hardly the case with e.g. the switch-over clause which results in taxation at the

[1] See e.g. letters from US Congress to the Treasury Department on June 9 and August 27, S2015 as well as testimony of Robert Stack to Senate Finance Committee on December 1, 2015.

shareholder level and has nothing to do with base erosion within the internal market. Furthermore, the provisions extracted from the CCCTB proposal (the deductibility of interest, the switch-over clause, the general anti-abuse rule and the CFC rules) were part of a broader, consolidated regime across countries with clear ambitions to enhance growth, employment and investment in the EU. The measures now proposed by the Commission will be directed against other Member States as well as third countries. The aim is not to promote a single uniform market but to create tax barriers in certain circumstances. This will have a negative impact on trade and growth.

In contrast to domestic legislation, when in place, a Directive is extremely difficult to change. Consequently, there are very good reasons for conducting a thorough analysis before going forward with any material provisions that could have an impact on the investment climate in Europe. For this new proposal however, there is no analysis regarding the effect on economic growth, employment or the impact on the EU's investment environment relative to the rest of the world. The manner in which the Commission is trying to rush a comprehensive package of new repressive measures in a Directive, without a proper impact assessment and sufficient time for stakeholder and Member State input, is simply not acceptable.

The proposal focuses mainly on areas in which the OECD has recommended best practices or has made no recommendation at all. Introducing these provisions as minimum standards in contrast to OECD-BEPS recommendation could put European companies in a competitive disadvantage with the rest of the world with the risk of driving key entrepreneurial & management functions out of the EU. The US Congress has repeatedly expressed that it would only accept OECD-BEPS changes supportive of US businesses and the US economy. This view has been endorsed by the US government.

The key to the BEPS project´s success is consistent application. A majority of the EU Member States are members of the OECD. By deviating from the international agreements made at the OECD level, the EU will introduce double or multiple standards undermining the consistency of the international tax system. Measures like the switch-over clause will also require renegotiation of a large number of tax treaties as well as amendments of rules on participation exemption.

NSD does not believe that the draft Directive will ensure a consistent implementation of the OECD’s recommendations within the EU. As stated above, the proposed minimum standard is not likely to solve the problem of fragmentation. An agreed statement at an ECOFIN meeting confirming that all Member States will revise their national tax systems to be consistent with the OECD’s recommendations should be more appropriate at this stage. If desired by Member States, the Commission could be given a role to review whether appropriate changes have been made in line with such a commitment.

We are concerned that the draft Directive reduces the flexibility for Member States to adjust their national tax systems in the future. National governments should be allowed to legislate in an open and transparent manner without running the risk that the right to tax an economic transaction is transferred to another Member State. The explicit or implicit elements of extra-territorial taxation is not conducive to either economic efficiency or to national tax sovereignty. Several proposals from the Commission have lately included such features (the FTT for instance). To continue on such a path is very worrisome, in particular for smaller Member States.

We are also concerned that "the Commission will [therefore] work to include state aid provisions in negotiating proposals for trade and association agreements with third countries, with a view to ensuring fair tax competition with its international partners". An increase of non-tariff barriers must be resisted.

Specific concerns

Interest deductibility

From a principal point of view NSD favours interest limitation rules based on objective criteria, like the one in the draft Directive, over the current interest limitation rules in Sweden, which are very unpredictable and lack an acceptable degree of legal certainty.

However, by setting a cap of 30 percent of EBITDA, with the possibility for Member States to introduce stricter rules, the interest limitation rule in the draft Directive goes beyond the 10-30 percent of EBITDA corridor recommended by the OECD.

NSD is of the view that neither the OECD nor the EU-Commission has taken into consideration the various conditions prevailing in different countries.

Within a multinational enterprise (MNE) the borrowing for the entire group is often made through the parent company (HQ/intra bank), with the benefits that follows such an arrangement. If the HQ is located in a large country with a big home market, the EBITDA of the HQ will most likely be higher than if the HQ is located in a country with a small home market. Hence, bigger countries have a distinct advantage over smaller countries in attracting HQs if both countries apply the same EBITDA-ratio. The advantage for MNEs with HQs in large countries can e.g. be decisive in a situation where two MNEs are competing over the acquisition of a company and both MNEs need to finance the acquisition with debt. In such a situation, the MNE with its HQ located in a big home market will, to a greater extent, be able to deduct the interest costs. In this context, it needs to be recognized that it is often not possible to allocate interest costs from the HQ to its subsidiaries.

Despite being a small country, Sweden has many MNE HQ. For most of these MNEs, the Swedish market contributes only to a minor portion of their total

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sales, which gives a low EBITDA in Sweden. Consequently, it is crucial for the competitiveness of Swedish companies and the Swedish economy that Sweden has a relatively high cap of EBITDA. Without competitive rules, there is a distinct risk that some of these MNEs, in order to stay competitive, need to move their HQ to a country with less restrictive interest limitation rules.

The small country disadvantage is not mitigated by the group ratio clause in paragraph 3 in the draft Directive. MNEs from large economies generally have a higher indebtedness. The group ratio rule will therefore be more favourable for MNEs based in large countries.

Smaller economies have no way of addressing the above-mentioned distortions. The fact that these issues were not analysed by the OECD is perhaps not surprising, considering that the BEPS project was orchestrated by G20, being the 19 biggest countries in the world. However, considering the fact that many EU Member States have small home markets, it is more surprising that the EU has not elaborated on these differences.

An EU cap of 30 percent EBITDA in a Directive will seriously limit the possibility for future upward adjustments, with a negative impact on the investment, economic growth and competitiveness in the European Union. In addition, it will place Sweden and other small open economies in the EU at a considerable competitive disadvantage vis-a-vis bigger countries. NSD can therefore not support such a proposal.

In article 2 paragraph 1 there is a definition of ‘borrowing costs’. NSD finds this definition far too vague and difficult to interpret. This level of uncertainty regarding the interpretation is not acceptable in a Directive. NSD would like to call to attention the heavy criticism that was directed at Företagsskattekommittén’s definition of interest (finansiell kostnad). In OECD’s BEPS action point 4, it is expressed that certain foreign exchange losses on borrowings and instruments could be included in the definition of interest. The OECD does however not offer any guidance on how to apply this in practice. As far as NSD is aware, no country has successfully included foreign exchange losses in their interest limitation rules in a way that makes it simple and predictable for the taxpayer. It is unclear whether or not foreign exchange losses is covered by the definition in the draft Directive. For the reasons just described, and NSD is of the opinion that such losses should be excluded. It can also be questioned whether a inclusion of foreign exchange losses is compatible with EU law[2]. A clear definition of borrowing costs is crucial in order to have interest limitation rules that are predictable and easy to apply. There is also an imbalance in the formula for calculating the net interest income/cost. The income to be included is much narrower compared to the costs being included. The determination of what to include in income and costs should be more uniform.

[2] HFD Mål nr 3238-12.

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The proposal in the draft Directive makes it possible to carry forward borrowing costs that has not been deducted, as well as unused EBITDA capacity. NSD strongly support this, since it will make it possible for companies with fluctuating earnings to reduce the negative impact that the interest limitation rules would otherwise have.

Several Member States, including Sweden and other small economies, use a group contribution system (koncernbidrag) instead of group consolidation. The EU-Commission fails to address how such a system can function in conjunction with the proposed interest limitation rules.

It is notable that the OECD recommended a Group ratio rule based on net interest to EBITDA ratio whereas the EU draft Directive proposes such a rule based on the debt to equity ratio in each company compared to the same ratio in the whole group. The fact that the EU-Commission's proposal deviates from the BEPS-recommendations is clearly not consistent with the proposed goal of a uniform implementation.

NSD shares the view that the interest limitation rule shall not be applied to financial undertakings. However the exemption of financial undertakings raises several questions. There is no guidance how to apply the Group ratio rule for a Group that has both entities that are subject to the interest limitation rules as well as entities that are exempt. In such a situation, shall the group ratio be based on the entire group or should financial undertakings not be considered when calculating the group ratio? This is just one example of the many difficulties the exemption will give rise to. NSD calls for much more guidance and clarity in this regard.

As a final reflection, IASB has developed new accounting standards for leasing that will come into effect 2019. The new standards will have an impact on e.g. a Group ratio rule. Introducing minimum standards in a Directive that limits the possibility to adjust to future changes like this is, to say the least, highly questionable.

Exit tax

A proposal for exit taxation is not included in the BEPS recommendations, nor does it belong in the Internal Market. Exit taxation often results in double taxation. It is also questionable whether the proposal is consistent with the jurisprudence of the European Court of Justice (ECJ) as it is likely to result in an unjustified restriction on the fundamental freedoms, such as the freedom of establishment and the freedom of movement of capital. With this in mind, it is difficult to view the proposal as a minimum standard since a stricter legislation likely would be a breach of EU law.

Many countries have some form of exit tax and need to respect the limitations set forth in ECJ case law. If other countries wanted to adopt such a provision,

but for various national policy reasons have chosen not to do so, the national tax sovereignty of the Member States should be respected.

Furthermore, the proposed exit tax clause in the draft Directive also seems to go beyond what is necessary to combat tax avoidance as the proposal covers situations where the Member State continues to have tax jurisdiction over the assets that are transferred, such as in the case of transfers of assets from a head office to a permanent establishment in another Member State.

Switch-over clause

A switch-over clause is not included in the OECD-BEPS recommendations. This is not surprising since such a measure clearly diverts from the principle of taxing profits where the economic activities take place and the value is created. In fact, this is the provision in the draft Directive that strays furthest from merely tackling base erosion and profit shifting and has the greatest likelihood of impeding national tax sovereignty. It forces Member States to abandon the long-established principle of capital import neutrality by effectively turning a Member State's exemption system into a credit system, without regard to whether there is substance or an appropriate level of activity in the subsidiary. The principle of capital import neutrality has traditionally been used by smaller Member States such as e.g. Sweden. However, in recent years it has also been adopted by countries such as Germany and the UK, and it has been proposed in the US as an essential feature in a much-needed reformed tax system. Capital import neutrality is also an important principle in order to foster efficiency and growth in an economic union.

This proposed clause will also impact legitimate business structures where the country of investment may have determined, for legitimate national policy reasons, to apply a low corporate income tax rate in order to encourage investment and attract business operations. Investments in genuine economic activities should not be considered tax avoidance simply because they are located in low tax jurisdiction. Furthermore, it is also likely that the proposed switch-over clause will disproportionately affect investment in developing countries, which often use competitive corporate tax rates or tax-reducing incentives to attract foreign investment.

Many Member States have tax treaties with exemption provisions. Without a safe-harbor clause, a measure like the switch-over would clearly require renegotiation of a large number of bilateral tax treaties.

A switch-over clause is sometimes used by countries as an alternative to CFC rules. In the draft Directive, however, it is proposed to be applied in conjunction with CFC rules, with the risk of multiple taxation and interaction with participation exemption rules as a result. In addition, it looks at national statutory rates. Since it is the statutory rate in the Member State receiving the income

that will be decisive for the application of the measure, it will be enacted differently within the EU causing a distorted and fragmented, as opposed to uniform, tax environment. Such a scenario does not facilitate a level playing field and may very well be in violation of EU law. At the outset of the CCCTB, the switch-over clause was seen as THE anti-abuse measure, applied uniformly. The present proposal is anything but the original proposal.

From a purely Swedish perspective, a switch-over clause is likely to affect some of our tax treaties and could also eliminate the relief available under the Swedish rules on dividend participation exemption (utdelning på näringsbetingade andelar).

General anti-abuse rule

A general anti-abuse rule (GAAR) is not included in the OECD-BEPS recommendation.

The proposed GAAR may be in conflict with national GAARs and developed case-law. It may also be in conflict with other EU GAARs as the one contained in the Parent-Subsidiary Directive ("main purpose or one of its main purposes" instead of "essential purpose") or the one contained in the Recommendation on the tax treaties ("unless it is established that it reflects a genuine economic activity"). Irrespective of whether the test rely on the main purpose or one of the main purposes or the essential or principal purpose (as stated in relation to the principal purpose test in BEPS 6), the focus of any EU purposed GAAR must be on the artificiality of the arrangement as such and not only on the purposes or intentions when entering into the arrangement.

For an EU GAAR to work effectively, it must be consistently interpreted and applied by the different Member States. However, it should be noted that it is very difficult to draft a wording that is appropriate in each territory given different systems and varying needs in different Member States. For example, the ATAP refers to the 'object or purpose' of the applicable tax provisions, but such terminology is frequently not clear and is often subject to debate and misinterpretations.

The fact that some countries, e.g. the UK, spent years crafting their GAAR shows the complexity and the time frame required to get it right. Rushing through some quickly put together wording that is intended to apply in all Member States despite their different legislative positions and case law is not appropriate.

Without sufficient clarity, the GAAR will have a negative impact on business investment between EU Member States and inbound investments from third countries into the EU.

CFC legislation

The OECD concluded that CFC rules should be addressed at a national level, recognizing that countries will want to implement the most appropriate regime to complement their wider corporate tax strategy. The draft Directive, on the other hand, proposes a much more rigid "one fits all" framework, with little room for adjustment at the national level.

Whilst shareholdings in establishments of other EU Member States are excluded, where investments outside of the EU are made through a chain of entities in multiple Member States, it appears that each Member State could seek to tax the income simultaneously. There is no mechanism in the draft Directive indicating that such taxes would be creditable against another tax. It is also not clear which Member State (if any) would have predominant taxing rights. Ultimately this could lead to many layers of taxation on the same income, without ever receiving a credit. Additionally, different tax rates and holding percentages in different Member States will mean that the rules will apply in different EU holding companies at different times, making the rules incredibly complicated to apply in practice.

In addition, using effective rates of taxation instead of blacklisted countries or statutory rates of taxation will increase the administrative burden since it will require repetitive analysis to be completed each year. Furthermore, the measure gives different results for different Member States. The rationale behind this is unclear and the provision may potentially be in breach of EU law.

The fact that the draft Directive discriminates against genuine economic activity in non-Member States is also questionable since it may have a negative effect on the economic interests and attractiveness of countries which introduces CFC rules in this form. It is certainly not justifiable for the EU to over-ride the national tax sovereignty of Member States by forcing such action upon them.

Finally, a small but potentially important observation. The OECD uses the concept "significant people functions". The wording in Article 8.2 of the draft directive, however, is "significant people´s functions". Whereas the OECD concept concerns *significant functions* performed by people the concept in the draft Directive implies that the functions performed by *significant people* should be decisive.

Hybrid mismatches

The draft Directive also takes a different approach than what the OECD recommends to determine whether there is a hybrid financial instrument, looking at only legal characterization and a different approach to the counteraction, by requiring that the income be taxed in the country receiving the payment – rather than denying the tax deduction in the country where the payment has its

source. If Member States are to implement the proposed rules for hybrid instruments with counterparties within the EU while adopting the OECD recommended rules for third country counterparty instruments, this will lead to different sets of rules, depending on where the counterparty is located. This inconsistency and double standards would increase the risk of mismatches as well as the administrative burden for companies. Also in relation to this issue, since the draft Directive only concerns hybrid instruments within the EU, would not the subject to tax provision in the parent subsidiary directive be sufficient?

It is important that the government protect Swedish national interest by opposing the Directive.

NÄRINGSLIVETS SKATTEDELEGATION

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