The Anti-Tax Avoidance Directive in Ireland: Winds of Change or an Easterly Breeze?

Joe Duffy *Partner, Matheson*
Tomás Bailey *Solicitor, Matheson*

Introduction

The Anti-Tax Avoidance Directive (ATAD) was formally adopted by the Economic and Financial Affairs Council of the European Union on 12 July 2016. The ATAD will have a significant impact on Irish tax law. However, the practical impact of the provisions of the ATAD on taxpayers in Ireland with cross-border operations will largely depend on how the provisions are implemented into Irish law.

Like all Directives, the ATAD is binding as to the results it aims to achieve and Member States are free to choose the form and method of achieving those results. In addition, the ATAD contains a number of optional provisions that present an element of choice as to how it will be implemented into Irish law. A considered implementation of the ATAD will be crucial to ensure that this optionality is exercised in a manner that is consistent with Ireland's established international tax policy.

The ATAD: An Overview

The ATAD is designed to target corporate taxpayers in the EU with cross-border operations. The stated objective of the ATAD is to provide for the effective and swift coordinated implementation of anti-base erosion and profit shifting measures at EU level.[1] However, the ATAD goes significantly further than the OECD's BEPS proposals by treating all BEPS measures (i.e. minimum standards, common approaches and best practices) as minimum standards in tax policy. The ATAD has been described as supranational law that, unlike BEPS, has been forced on Member States without any coherent, analytical or reasoned opposition.[2]

The ATAD comprises five operative components:

- interest limitation rules,
- controlled foreign company (CFC) rules,
- exit tax,
- general anti-abuse rule (GAAR) and
- anti-hybrid rules.

The ATAD must be transposed into Irish law by 1 January 2019, with the exception of the interest limitation rules (1 January 2024) and the exit tax (1 January 2020). Although it is difficult at this stage to determine with precision the impact that the ATAD will have when transposed in light of its optional provisions, its scope and objectives are clear. Affected taxpayers should therefore begin to analyse the potential impact of the ATAD on their businesses.

Interest Limitation Rules

Overview and operation

The most significant provision of the ATAD in practice is likely to be the introduction of fixed-ratio interest limitation rules contained in Article 4. The article operates to deny a deduction in respect of net interest expense (being gross interest expense less interest income) that exceeds 30% of the taxpayer's EBITDA.[3]

The limitations provided for in the article can be applied on an entity-by-entity level or at group level. The article provides that Member States can include grandfathering for loans agreed before 17 June 2016 and a *de minimus* exemption of up to €3m net interest expense.

Deductions for interest payments will be denied under the interest limitation rules regardless of whether the interest is paid to a third party or intra-group and regardless of where the recipient of the interest is located. Taxpayers should be entitled to carry forward excess net interest indefinitely.[4]

Implementation in Ireland

The interest limitation rules will be of most relevance to leveraged companies operating in Ireland with a significant annual interest expense. It is anticipated that Ireland will exercise the discretion afforded by the optionality under Article 4 to limit any adverse impact on implementation, particularly on the financial services industry, which has been a key component of the economic recovery in recent years. In this respect, when implementing the interest limitation rules Ireland may opt:

- not to apply the rules to limit the deductibility of interest paid on loans agreed before 17 June 2016;
- not to apply the rules to interest payments on loans to fund long-term public infrastructure projects;
- to exclude financial undertakings (i.e. banks, investment firms, pension funds, UCITS,[5] alternative investment funds, insurers and reinsurers, central counter-parties and depositories);
- to include a *de minimus* threshold and permit net interest payments of up to €3m to be deducted, regardless of a taxpayer's EBTIDA;
- to include an exemption for standalone entities (i.e. a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment (PE));
- to include a group interest carve-out provision that permits taxpayers to deduct net interest exceeding the 30% threshold if the taxpayer's net interest to EBITDA ratio is no higher than the net interest to EBITDA ratio of the worldwide group; and

1 Paragraph (2), ATAD Preamble.
2 Tom Wesel and Zoe Wyatt, "Examining the Revised EC Anti-Tax Avoidance Directive", *Tax Journal* 1317 (2016), at p. 10.
3 Earnings before interest, tax, depreciation and amortisation.
4 Article 4(6) of the ATAD provides that Member States may, in addition to permitting indefinite carrying forward of excess net interest, provide for the carrying back of net interest for up to three years, or for the carrying forward of unused interest capacity for a maximum of five years.
5 Undertakings for collective investment in transferable securities.

› to include a group equity carve-out provision that permits taxpayers to deduct net interest exceeding the 30% threshold if the taxpayer's equity to total assets ratio is higher than (or at least no more than 2% lower than) the equity to total assets ratio of the worldwide group.

Transposition

The interest limitation rules must be transposed into Irish law by 1 January 2019 unless the derogation under Article 11(6) applies on the basis that Ireland's existing targeted rules preventing base erosion and profit shifting are equally effective as the interest limitation rules.[6] If the derogation applies, the interest limitation rules must be implemented by 1 January 2024.

Impact of the rules

To ascertain the potential impact of the interest limitation rules, domestic groups and multinational groups with Irish operations should review their current financing structures in respect of Irish and EU entities, identifying entities that might exceed the 30% limit. Groups should carefully consider the impact that the interest limitation rule will have on new loans (i.e. loans agreed on or after 17 June 2016) agreed by Irish companies. However, any responsive action to the interest limitation rules should be postponed until taxpayers have reviewed relevant Irish Government policy documents and the implementing legislation.

In general, Irish entities in multinational groups tend not to be heavily leveraged in light of the restrictive nature of Irish tax provisions on interest when compared with other jurisdictions. Furthermore, many Irish treasury companies may not be affected by the interest limitation rules on the basis that the interest receipts of such companies should exceed their interest expenses.

The interest limitation rules may be more significant on certain sectors. For example, taxpayers operating in the asset leasing sector in Ireland will need to consider carefully the provisions adopted under the implementing legislation to minimise the potential impact of the rules on their operations. The implementation of Article 4 will be particularly relevant to such taxpayers to ensure that they are not unduly affected by the rules. The group interest and equity carve-outs, the *de minimus* exemption and the carry-forward provisions are likely to be very important in this respect.

Controlled Foreign Company Rules

Overview

At present, general CFC rules do not exist in Irish tax law. Ireland will therefore be obliged to introduce entirely new legislative provisions before the 1 January 2019 implementation date to give effect to the CFC rules contained in Article 7 of the ATAD. However, the impact the CFC rules will have in practice on taxpayers in Ireland with cross-border operations may be somewhat mitigated in light of Ireland's existing substance-based regime and relatively low headline rate of corporation tax.

The implementation of Article 7 will introduce of an additional layer of complexity to establishing business operations in the EU for taxpayers in Ireland with cross-border operations. This complexity is compounded by the fact that the formulation proposed under Article 7 departs from established principles of law and may provide for the dilution of a taxpayer's freedom of establishment under EU law as promulgated by the Court of Justice of the European Union (CJEU).

Operation of the rules

Article 7(1) of the ATAD provides that an entity or PE of which the profits are not subject to tax, or are exempt from tax, in a Member State should be treated as a CFC if:

› a resident taxpayer, directly or indirectly, owns greater than 50% of the entity's capital or is entitled to receive greater than 50% of the entity's profits and

› the effective tax rate suffered by the entity or PE on its income is less than 50% of the tax that would have been suffered had the income been taxed in the resident taxpayer's jurisdiction.

Member States can choose to impose the CFC charge on either (1) undistributed passive income of the CFC (including royalties, interest, dividends and income from financial leasing) or (2) undistributed income of the CFC arising from non-genuine arrangements.[7]

If the charge is imposed on undistributed passive income, CFCs carrying on substantive economic activity in a Member State supported by staff, equipment, assets and premises must be

6 In a press release dated 22 June 2016, the Irish Department of Finance indicated that Ireland would avail of the derogation, subject to the Commission's approval.
7 Article 7(2) ATAD.

exempt.[8] If the CFC charge is imposed on undistributed profits from "non-genuine arrangements", a *de minimus* exemption may be provided for[9] and the charge should be limited to profits generated through assets and risks that are linked to significant people functions carried out by the controlling company.[10]

An arrangement is treated as non-genuine to the extent that the controlled company would not own the assets or would not have undertaken the risks that generate its income if it was not controlled by a company where the significant people functions relevant to those assets and risks and instrumental in generating the controlled company's income are located.

Implementation in accordance with EU Law

EU Member States are obliged to implement the provisions of the ATAD in a manner that is consistent with EU law.[11] In implementing Article 7 of the ATAD, Member States will therefore need to ensure that the domestic transposing legislation does not infringe the freedom of establishment under Article 49 of the Treaty on the Functioning of the European Union (TFEU) or the free movement of capital under Article 63 of the TFEU, as interpreted by the CJEU.

Although a detailed review of the compatibility of Article 7 of the ATAD with existing principles of EU law is beyond the scope of this article, it is arguable that the CFC charge provided for under the ATAD may go beyond the boundaries established by the CJEU in *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*.[12] In this case, the CJEU held that the restriction imposed by CFC rules on the freedom of establishment is justifiable only where:

> *"...the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State...*[and is] *regarded as having the characteristics of a wholly artificial arrangement".*[13]

The CJEU's construction of a non-genuine activity as comprising a "wholly artificial arrangement intended solely to escape" tax[14] appears to be more compatible with non-genuine arrangements for the purpose of the GAAR under Article 6 than the CFC rules under Article 7.

The CFC charge under Article 7 of the ATAD can arise if the relevant CFC does not carry on substantive economic activity supported by staff, equipment, assets and premises, or if the CFC generates income from assets that it would not own or risks that it would not assume if it was not controlled by a company where relevant significant people functions are performed. It is possible that this scale-based standard could be viewed as going further than the substance requirements stipulated by the CJEU, resulting in an unjustifiable infringement of a taxpayer's freedom of establishment under Article 49 of the TFEU in accordance with CJEU case law.[15] Member States will need to consider carefully this risk on implementation.

Impact on subsidiaries in Ireland

In light of the relatively low headline tax rate on trading profits in Ireland, it is possible that many Irish subsidiaries of EU companies will be treated as CFCs in other Member States under the ATAD rules. Multinational groups with Irish subsidiaries that are held directly or indirectly by companies located in other EU Member States will therefore have to consider whether the income of their Irish subsidiaries could be subject to the CFC charge as applied by the tax authorities of other Member States. The application of the CFC rules to Irish subsidiaries will be influenced by the activities of the relevant entity.

Trading subsidiary

To qualify for the Irish corporation tax rate on trading profits, a company must generally have personnel in Ireland with the requisite skill and expertise to actively conduct its business. It is therefore anticipated that in most cases CFC charges should not be imposed on Irish trading entities by other EU Member States by virtue of the "substantive economic activity" carve-out, although the application of this position will be a matter for the tax authorities of the relevant Member States to determine. It should be noted that the scope of this carve-out is uncertain, given that it appears to depart from the standard prescribed in case law. In

8 The exemption for "substantive economic activities" may be extended to CFCs located in a third country at a Member State's discretion.
9 Article 7(4) ATAD.
10 Article 8(2) ATAD.
11 See joined cases *Metallgesellschaft Ltd and Others, Hoechst AG and Hoechst (UK) Ltd v Commissioners of Inland Revenue and HM Attorney General* C-397/98 and C-410/98; *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)* C-446/03.
12 C-196/04.
13 C-196/04 at para. 68. See also *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* C-524/04.
14 C-196/04 at para. 63.
15 Tom Wesel and Zoe Wyatt, "Examining the Revised EC Anti-Tax Avoidance Directive", *Tax Journal* 1317 (2016), at p. 12.

cases where the "substantive economic activity" carve-out is not satisfied (or a CFC charge is imposed by reference to non-genuine arrangements), no CFC charge will arise to the extent that the Irish subsidiary distributes income earned.

Non-trading subsidiary

Passive income earned by an Irish subsidiary is taxed at 25%, and limited deductions are available for expenses incurred by such entities. It is less likely that Irish companies earning passive income will be taxed at an effective tax rate that is less than half of the rate imposed in the taxpayer jurisdiction, and therefore, in most cases, those entities should not be treated as CFCs by other EU Member States under the terms of the ATAD.

Impact on holding companies in Ireland

For the first time, Irish holding companies will have to consider whether any of their subsidiaries are CFCs. It is unclear at this stage which method Ireland will adopt to determine the CFC charge (i.e. undistributed passive income or undistributed income from non-genuine arrangements). The appropriate corporation tax rate applicable to determine whether a trading subsidiary is a CFC is also somewhat unclear. As noted, the corporation tax actually paid by the subsidiary is compared to the corporation tax that it would have paid in Ireland for this purpose. The profits of a foreign trade are taxed under Case III in Ireland at 25%. However, it is submitted that the trading rate of 12.5% should be applied in this context, given that the comparison is specifically based on the tax rate that would have been applied to the CFC in Ireland, not the tax rate applicable to the profits that it generates in its home jurisdiction. This approach is consistent with the general scheme of the CFC fiction, which focuses primarily on the nature of the activities in question. In any event, it is unlikely that Case III would apply where the trading activities were subject to the oversight of the controlling company. Clarification of this point in implementing legislation would be welcomed.

Once implementing legislation becomes available in the key EU Member States where a multinational group operates, it may be necessary to review existing EU holding structures in light of the new CFC rules under the ATAD. In future years, therefore, it may be more efficient for holding companies to be located in a low-tax jurisdiction such as Ireland.

Exit Tax

Scope of application

Article 5 of the ATAD provides that Member States will be obliged to impose an exit tax (a tax on the difference between the market value of the assets and the value of the assets for tax purposes) on the following transactions:

- the transfer of assets to a PE of the taxpayer in another jurisdiction, which must be taxed by the head-office jurisdiction if the assets leave the tax net of the head-office jurisdiction;
- the transfer of assets of a PE to head office or to a PE in another jurisdiction, which must be taxed by the transferring PE jurisdiction if the assets leave the tax net of that jurisdiction;
- the migration of residence of a taxpayer to another jurisdiction; and
- the transfer of a business carried on by a PE in a Member State to another jurisdiction if the assets leave the tax net of the transferring PE jurisdiction.

The exit tax applies to the difference between the market value of the asset and the value for tax purposes at the time of the relevant transaction. Member States to which the assets are transferred are obliged to accept the market value of the assets as ascertained by the Member State imposing the exit tax.[16]

The ATAD does not confirm how Member States should determine the value for tax purposes of assets that have entered a Member State's tax net from a third country. To ensure coherency in the tax system, it logically follows that the tax value of such assets should equal the market value of the assets when they enter the Irish tax net. However, unlike that of other EU Member States, Irish tax law does not currently provide for a general step-up in tax value when assets come within the Irish tax net. Therefore, the exit tax could result in the imposition of a greater tax burden on assets exiting Ireland. To address this position, Irish tax law should be updated to provide for a general step-up in tax value for assets entering the Irish tax net.

Article 5 must be implemented by 1 January 2020.

16 Article 5(5) ATAD.

Impact of exit tax

Under existing Irish tax law, the transactions listed would not generally trigger a charge to tax in Ireland because (1) Ireland does not generally treat the allocation of assets to a PE or back to head office (or to another PE of the same taxpayer) as a disposal for tax purposes[17] and (2) the tax charge that arises on the migration of a company from Ireland is designed to apply in narrow circumstances[18].

If the transferee jurisdiction is an EU or EEA member, taxpayers must be permitted to defer payment of the exit tax by spreading payment over five years.[19] It is not possible to defer the exit tax until a gain on the assets is actually realised.[20]

The exit tax provisions should not apply until 1 January 2020, giving businesses that are contemplating ultimately relocating part of their business from Ireland some time to consider the impact of the provisions.

General Anti-Abuse Rules

Overview and implementation

Article 6(1) of the ATAD contains a broad GAAR that requires Member States to ignore:

> *"an arrangement or series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances".*

An arrangement will be treated as "non-genuine" to the extent that it is not entered for valid commercial reasons that reflect economic reality. An arrangement that falls foul of the GAAR is ignored, and tax is computed in accordance with relevant domestic law.

The GAAR must be implemented by 1 January 2019.

Impact of the GAAR

Irish tax law already contains a GAAR. It is unclear whether the existing Irish GAAR in s811C TCA 1997 will be regarded as adequate implementation of article 6 of the ATAD or if a new GAAR will be introduced into Irish law.

For the GAAR under Article 6 to apply, the relevant arrangement must defeat the purpose or object of domestic tax law. This construction opens the Irish tax system to the scrutiny of the CJEU by conferring it with jurisdiction to review and pronounce on the purpose or object of domestic tax law. In this context, Article 6 adds an additional layer of uncertainty for taxpayers operating in the EU by exposing domestic tax infrastructures to the ultimate review of the CJEU.

Furthermore, taxpayers in Ireland that engage in intra-EU transactions will be subject to the GAAR as applied in a cross-border context by the tax authorities of the relevant Member State. It has been suggested in this context that the GAAR could become "a stick with which Member States…can beat one another where they do not like the outcome of the application of domestic law".[21]

Anti-Hybrid Rules

Overview and operation

Article 9 of the ATAD provides for the introduction of anti-hybrid rules into Irish tax law. The anti-hybrid rules must be implemented by 1 January 2019.

The anti-hybrid rules apply to situations between associated taxpayers in two or more Member States or structured arrangements between parties in Member States that, arising from differences in the legal characterisation of a financial instrument or entity, result in:

- a double deduction (i.e. a deduction for the same payment, expense or loss in two different Member States) or
- a deduction without inclusion (i.e. a payment that is deductible for tax purposes in the payer's jurisdiction but is not included in the taxable income of the receiving taxpayer).

If the mismatch results in a double deduction, the relevant payment will be deductible in the source Member State only. The ATAD does not provide any guidance on identifying the source

17 Although see s620A TCA 1997 in the context of assets acquired by a company that came within s615, s617 or s620 TCA 1997.
18 Section 627 TCA 1997 contains the existing Irish exit tax, which is imposed on companies that cease to be tax resident in Ireland. The exit tax is triggered by way of a deemed disposal and reacquisition of the migrating company's assets at market value. The existing exit tax is subject to broad exemptions, however, and is not often triggered in practice.
19 Article 5(3) of the ATAD provides that Member States can impose interest in accordance with domestic law on taxpayers who defer payment of the exit tax. In addition, Member States can make deferral subject to receiving a guarantee where there is a demonstrable or actual risk of non-recovery of the exit tax.
20 In *National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam* C-371/10 the CJEU held that an exit tax imposed by a Member State that provides for the immediate recovery of tax on unrealised gains was contrary to Article 49 of the TFEU (freedom of establishment) and was therefore unlawful. It is difficult to see how Article 5 of the ATAD can be reconciled in this regard. See Tom Wesel and Zoe Wyatt, "Examining the Revised EC Anti-Tax Avoidance Directive", *Tax Journal* 1317 (2016).
21 Tom Wesel and Zoe Wyatt, "Examining the revised EC Anti-Tax Avoidance Directive", *Tax Journal* 1317 (2016), at p. 11.

jurisdiction of a payment in this regard. If the mismatch results in a deduction without inclusion, the deduction must be denied in the Member State of the payer.[22]

Impact of the rules

The Irish tax system is relatively straightforward, and it is unusual to see Irish instruments or entities that have a different legal characterisation in another EU Member State. The provisions of Article 9 in their current form may not therefore have significant implications on many Irish taxpayers.

The anti-hybrid rules under Article 9 of the ATAD in their current form apply only where a hybrid mismatch arises between two Member States. They do not apply to transactions that result in a hybrid mismatch between an EU Member State and a third country (e.g. the US). However, an amendment to the ATAD was proposed on 25 October 2016 by the European Commission. The main changes proposed are to extend the scope of the anti-hybrid provisions to transactions and arrangements with taxpayers in third countries. The proposed draft anti-hybrid rules could, in certain circumstances, impact on the tax treatment of an Irish group company that is treated as a disregarded entity under US tax law. In addition, the ability of Irish taxpayers to deduct intra-group payments may be limited in a number of circumstances under the provisions of the proposed directive. The provisions are currently in draft form only and are expected to be progressed at EU level before the end of 2016. It will be important for many Irish taxpayers to carefully monitor the progress of the draft directive through the EU legislative process.

Comment

The ATAD was enacted to prescribe common standards with a view to coordinating the implementation by EU Member States of the OECD's BEPS action items.[23] However, the ATAD goes further than the BEPS action items by including the exit tax and the GAAR. The implementation of the ATAD will result in an unavoidable surrender of national sovereignty in the area of taxation. By prescribing common tax measures, the ATAD will inhibit the tax competitiveness of EU Member States and will further the "creeping harmonization of tax law" in Europe.[24] It is important that Ireland remain committed to preserving its sovereign competence in taxation in order to further its stated policy objectives of using taxation as a key policy tool to develop the most competitive corporate tax offering in conformity with good practice.[25]

The implementation of the ATAD will have a significant direct impact on the tax legal infrastructure in Ireland. In addition to providing for the introduction of entirely new concepts, certain elements of the Irish tax infrastructure will need to be realigned to complement the implementation of the ATAD measures. For example, at present, Irish corporation tax is chargeable on unrealised capital gains that have come into the Irish tax net from a third country when the gain is eventually realised. This position should be restricted to protect against double taxation and to align with the tax methodology envisaged by Article 5 of the ATAD. In addition, the exit tax is likely to trigger the need for the introduction of a branch exemption into Irish tax law. These measures would operate to shift the Irish tax system further toward a more territorial-based system. The introduction of a participation exemption would complement such a shift.[26] The reforms required to ensure coherency in the tax system after ATAD implementation should be considered as part of the corporation tax review launched in Budget 2017.

The practical impact of the implementation of the ATAD on taxpayers in Ireland with cross-border operations will ultimately be determined by the provisions of the implementing legislation. A detailed and constructive consultation process on the implementation of the ATAD provisions will be vital in this respect to ensure that Ireland's discretion is exercised in a manner that best serves stated tax policy objectives. Taxpayers should actively engage in the consultation process and should be proactive in responding to implementing measures that could adversely affect their operations.

Read more on taxfind European Commission released new package of corporate tax reforms including CCCTB proposals, Institute Bulletin, October 2016; *Direct Tax Acts*

22 It has been suggested that the anti-hybrid rules may be contrary to the case law of the CJEU on the basis that they involve determining a company's tax treatment in one jurisdiction by reference to its treatment elsewhere. The rules are likely to be interpreted restrictively. See J.P. Finet, "Hybrid Mismatch Rules Expected to Raise Issues for CJEU", *Tax Notes International* 84(3) (2016), at p. 244.

23 Recital 3 of the ATAD.

24 Comment by Bob Stack at the International Fiscal Association meeting in Barcelona on 24 September 2016. Cited in Lee Sheppard, "Notes from the Tax Wars", Tax Notes International 84(1) (2016), at p. 17.

25 See Department of Finance, *Competing in a Changing World – A Road Map to Ireland's Tax Competitiveness* (2014); *Update on Ireland's International Tax Strategy* (2015); and *Update on Ireland's International Tax Strategy* (2016).

26 The introduction of a participation exemption could be subject to a "switch-over" clause if introduced when the ATAD is reviewed by the Commission four years after its implementation in accordance with Article 10.