Tax Alert

Akin Gump
STRAUSS HAUER & FELD LLP

European Tax Update January 2019

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We set out below a recap of some of the key European and international tax developments to note at the start of 2019. This alert provides a brief summary of the following:

I. the implementation, from 1 January 2019, by all EU Member States of certain anti-tax avoidance measures, which is likely to have an impact on the effective tax rate of a number of international groups (including common fund structures) involving EU taxpayers;

II. the introduction of the EU's Mandatory Disclosure Regime for intermediaries, which will require lawyers, accounting firms and other similar "intermediaries" to disclose the details of a wide range of transactions implemented on behalf of their clients to EU tax authorities;

III. an update on the status of the OECD's "Multilateral Instrument," with a focus on the introduction of the "principal purpose test," which will have the effect of tightening the conditions for taxpayers to obtain relief under certain double tax treaties; and

IV. as no European 2019 development update would be complete without a reference to Brexit, a reminder of some of the key tax points to be aware of should the U.K. leave the EU.

Implementation of EU Anti-Tax Avoidance Directive Measures from 1 January 2019

Summary: The EU Anti-Tax Avoidance Directive (2016/1164 of 12 July 2016) ("ATAD") requires EU Member States to implement a range of anti-tax avoidance measures into their national law from 1 January 2019. The ATAD measures requiring introduction from January this year include a limitation on the ability to take tax deductions for interest expense, a general anti-abuse rule and a rule requiring the attribution of certain non-distributed profits of "controlled foreign companies" to their EU shareholders. The ATAD changes are expected to have a material impact on the tax regimes of many EU Member States, perhaps most notably, in the context of investment fund structures, Ireland and Luxembourg.

Contact

Sophie Donnithorne-Tait
Email
London
+44 20.7661.5312

Stuart Sinclair
Email
London
+44 20.7661.5390

Jonathan Rosen
Email
London
+44 20.7012.9657

Serena Lee
Email
London
+44 20.7012.9650

Overview of ATAD measures: The ATAD requires EU Member States to enact the following three anti-tax avoidance measures into their domestic legislation with effect from 1 January 2019.

Interest Limitation Rule: This rule was introduced to prevent international groups from reducing the taxable profits of group companies resident in high-tax jurisdictions by overly debt-funding these companies so that they can claim "excessive" tax deductions for interest expense. The general rule is that net borrowing costs (including interest expense and other costs incurred in connection with the raising of finance) will only be tax-deductible against up to 30% of a taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA).

The ATAD includes some flexibility for EU Member States to include (relatively limited) derogations in their domestic implementation of the rules, which would have the effect of lessening the impact on taxpayers in certain defined situations. Given this flexibility in implementation, the impact of the interest limitation rule will differ across the 28 EU Member States. For example:

- Ireland is currently taking the view that it already has "equally effective" domestic legislation and so can take advantage of the option to delay implementation of the interest limitation rule to, potentially, 1 January 2024. We understand that the Irish Government is currently engaging with the EU Commission on this issue. The conclusion of these discussions will be of particular relevance to fund structures which include Irish "110 companies" (which commonly utilise interest deductions to shelter non-interest-like profits from Irish tax).
- Perhaps unsurprisingly, Luxembourg has taken a relatively taxpayer-friendly approach to its implementation of the interest limitation rule by taking advantage of many of the options available to it to lessen the impact of the rules on taxpayers. However, we understand that the rules are expected to have a material impact on the effective tax rate of some common Luxembourg fund investment structures (such as using an unregulated TPEC-financed Luxembourg SARL to invest in distressed debt—as we understand that any return on the capital/principal element of the distressed debt may fall outside the calculation of "net" interest expense with the result that the TPEC interest/yield expense may only be deductible against up to 30% of any profit generated on the debt principal).

General Anti-Abuse Rule: EU Member States are required to implement a general anti-abuse rule into their domestic legislation which denies the advantageous corporate tax treatment of non-genuine arrangements where the main purpose or one of the main purposes of the arrangements was obtaining a tax advantage which defeats the purpose of the applicable tax rules.

Controlled Foreign Company (CFC) Rule: CFC rules are designed to dissuade groups from artificially shifting taxable profits to subsidiaries in low/zero tax jurisdictions by providing that the shifted profits are attributed to the relevant subsidiary's direct or indirect controlling shareholder based in a higher tax jurisdiction (such as jurisdictions within the EU). The ATAD allows EU Member States to choose from two implementation options in the context of the CFC rules: the first attributing to the relevant EU companies certain predefined categories of undistributed passive income (such as interest and royalties) of low-taxed CFCs without any substantive economic activity; and the second attributing undistributed income of the low-taxed CFC arising from non-commercial arrangements that were put in place to obtain a tax

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advantage. Each of Luxembourg and Ireland has chosen to adopt the second option. The rule also extends to profits generated by permanent establishments of EU corporate taxpayers. The ATAD CFC rules allow EU Member States to include certain exclusions from the application of the rules.

Further ATAD-related developments from 1 January 2020: The ATAD also requires the implementation of "exit tax" rules by EU Member States by 1 January 2020 (aimed at preventing taxpayers from avoiding tax by transferring assets to low-tax jurisdictions). There is a second Anti-Tax Avoidance Directive (commonly referred to as "ATAD 2") which requires EU Member States to adopt, largely by 1 January 2020, wide-ranging provisions to counter the effect of international structures taking advantage of hybrid mismatches (i.e., exploiting differences in the treatment of certain instruments and entities by two or more different taxing jurisdictions in order to reduce effective tax rates).

EU Mandatory Disclosure Regime

Summary: On 25 June 2018, an EU Directive (commonly referred to as "DAC6") entered into force, requiring EU "intermediaries" (which include law firms, accountants, tax advisors and corporate services providers) involved in certain cross-border arrangements to make a disclosure to their tax authority (e.g. HMRC in the U.K.) in certain circumstances. In limited circumstances, the disclosure obligation can also fall on the relevant taxpayer. The stated purpose of DAC6 is to strengthen tax transparency and fight against aggressive tax planning. However, as drafted, DAC6 will require the disclosure of a number of genuine commercial transactions, which may have no tax motivation. Although first reports are not due until August 2020, broadly, all reportable transactions implemented on or after 25 June 2018 must be disclosed. Failure to comply with the new mandatory disclosure regime may result in penalties for the relevant intermediary or taxpayer.

Which arrangements are reportable? A cross-border arrangement is only reportable where one or more "hallmarks" are present. Some, but not all, of the hallmarks apply only if the main or one of the main benefits of the arrangement is that a person may reasonably expect to derive a tax advantage from the arrangement. Hallmarks which we expect to be relevant to transactions that our clients enter into include: cross-border payments between related parties where the recipient is in a low tax jurisdiction or is not resident anywhere (such as a U.S. LLC or a partnership); transactions resulting in the conversion of income to capital (or other categories of revenue subject to lower tax rates); and certain intra-group cross-border transfers of functions, risks or assets.

Who needs to disclose? Law firms, accounting firms and other intermediaries providing aid, assistance, or advice on reportable arrangements (which may include managers of investment funds) are required to disclose. However, where legal privilege applies, lawyers will not be required to make a report. Where a number of intermediaries are involved in a particular transaction, only one must make the report (and the others' obligations are satisfied if they have proof that another intermediary has already made a disclosure). Where no intermediary is able to report (e.g., because they are prevented by legal privilege), the obligation to report will fall on the taxpayer itself.

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What information is disclosable? Broadly, DAC6 requires the disclosure of all the material details of a disclosable arrangement (for example: the identity of the relevant taxpayers; a summary of the substance and value of the transactions; and detail as to why the arrangement is reportable under DAC6) in order to assist the relevant EU tax authorities in determining whether to start an enquiry into the tax effect of the arrangements.

When is the deadline for disclosure? From August 2020, this information must be filed with the relevant tax authority within 30 days from when the reportable cross-border arrangement is ready/available for implementation or when the first step in the implementation has been made. Where the first step of any reportable arrangement is implemented between 25 June 2018 and 1 July 2020, these transactions must be disclosed by 31 August 2020.

U.K. implementation: The U.K. Government has stated that it will produce the necessary domestic legislation to implement DAC6 post-Brexit (anticipated to be included within the Finance Bill 2019). It is hoped that when the U.K. regulations are drafted they will clarify how the rules will apply in the U.K., and HMRC will provide more comprehensive guidance as to what should and should not be disclosed.

Principal Purpose Test for Double Tax Treaties

Summary: The OECD's "Multilateral Instrument" (MLI) came into effect with respect to withholding tax on 1 January 2019 in the U.K. and certain other jurisdictions. The immediate practical impact is to introduce a general principal purpose test (PPT) into the double taxation agreements (DTAs) entered into between certain of these jurisdictions with respect to withholding tax. The PPT does not yet apply to DTAs of Ireland, Luxembourg or the Netherlands, for which the PPT commencement date is generally expected to be 1 January 2020.

The PPT can operate to deny treaty benefits, such as reduced withholding tax rates, under a relevant DTA, if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining the relevant benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the DTA.

Background to the MLI: The MLI is part of the coordinated response to the OECD's recommendations arising from its Base Erosion and Profit Shifting (BEPS) project. The MLI enables participating jurisdictions to implement recommended changes to DTAs in an efficient way, without bilateral negotiations between jurisdictions on individual DTAs. The issues addressed by the MLI include treaty abuse, hybrid mismatch arrangements and permanent establishment avoidance.

Please see our previous alert for further background on the MLI: https://www.akingump.com/en/news-insights/uk-ratifies-the-oecd-s-multilateral-instrument-practical-impact.html

The following summary is intended to provide an update on certain key developments since that alert.

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Recent developments: During 2018 certain jurisdictions ratified the MLI and deposited the ratification instrument with the OECD prior to 30 September 2018, with the result that the MLI entered into force in those jurisdictions from 1 January 2019 with respect to withholding tax. For taxes other than withholding tax, the MLI will apply to relevant DTAs from the date falling at least 6 calendar months after the later of the date that the MLI enters into force in each relevant jurisdiction (unless a shorter period is notified). The jurisdictions which have elected to apply the PPT and for which the MLI is effective from 1 January 2019 include: Austria, France, Isle of Man, Israel, Japan, Poland, Singapore, Slovak Republic, Slovenia, Sweden and the U.K.

The MLI has not yet entered into force in Ireland, Luxembourg or the Netherlands (jurisdictions which are all commonly used in fund investment structures). However, these jurisdictions are at various stages of the ratification process, and it is generally expected that the MLI will enter into force in these jurisdictions during 2019, such that the PPT would come into effect for the withholding tax provisions of their DTAs from 1 January 2020.

Practical impact of the PPT: Whether the PPT is applicable to a particular bilateral DTA will depend on the position taken with respect to the PPT by the two jurisdictions concerned and the date of deposit of the ratification instrument with the OECD by each of the relevant jurisdictions (in order to determine the commencement date of any changes). This means that for any particular DTA under consideration, the position adopted by each of the counterparty jurisdictions to that DTA must be checked in order to determine the precise impact of the MLI on that DTA. The OECD has published on its website an “MLI Matching Database” (described as a tool that makes projections on how the MLI modifies a specific DTA covered by the MLI by matching information on the positions taken by counterparty jurisdictions), which may be of some assistance in any such assessment. However, the currently available database is a preliminary (beta) version and so should be used with appropriate caution; we would recommend referring to the source material when checking the status of a particular DTA with respect to the MLI.

The PPT is relevant to structures already in existence when the relevant PPT becomes effective, as there is no “grandfathering” provision. It is not yet clear how the U.K. will approach cases where a gross payment direction has been granted prior to the PPT becoming effective. There has also not been any change so far to the U.K.’s standard treaty forms in light of the PPT.

Brexit: Potential Tax Implications

Summary: The U.K. has now reached a critical point in the process of leaving the EU, which it is currently set to do on 29 March 2019 (Exit Day). Given that the withdrawal agreement negotiated by Ms. May (Withdrawal Agreement) was voted down on Tuesday 15 January, there is now further uncertainty around the U.K.’s future relationship with the EU. What is certain, however, is that a departure by the U.K. from the EU (in whatever form) would have an impact on the U.K. tax landscape, including, potentially, on overseas withholding tax exposure, VAT and the EU’s influence over U.K. tax policy.

In June 2016 we summarised some of the key tax implications of Brexit that are likely to be of particular relevance to the investment funds industry. This summary remains

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broadly relevant, though the position of several of the relevant matters is likely to be impacted by the terms of any agreed transition period and any negotiated withdrawal agreement with the EU. Since June 2016, we have had a helpful indication from the U.K. Government that there is no intention to reinstate the 1.5% stamp/SDRT charge on issuing shares to a clearance service or depositary referred to in our 2016 summary.

https://www.akingump.com/en/experience/practices/corporate/ag-deal-diary/brexit-key-tax-implications-for-alternative-investment-funds-and-1.html

In addition, non-U.K.-tax resident companies claiming benefits under a double-tax treaty between their jurisdiction of residence, such as Ireland, and the United States (U.S.) (for example, treaty relief from U.S. withholding taxes) may currently be relying on the fact that their ultimate ownership is sufficiently EU/EEA or NAFTA based to satisfy the conditions of the "limitation on benefits" provision in the relevant U.S. treaty. Many such companies would not be eligible for treaty benefits unless their ultimate U.K. ownership were taken into account in determining that the relevant ownership condition is met. The departure of the U.K. from the EU/EEA (and so from this list of eligible ownership jurisdictions in the U.S. tax treaties) may therefore lead to non-U.K. resident companies ceasing to be eligible for U.S. treaty benefits.

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