INTRODUCTION

1. At its meeting of 2 December 2008 the Council (ECOFIN) approved the future Work Package of the Code of Conduct Group (Business Taxation): “While noting the Commission’s work on coordination in this area, the Group would discuss what potential there is for a common political understanding of the latest position in European law and in particular what ‘genuine economic activity’ means within the context of anti-abuse rules in the EU” (doc. 16410/08 FISC 174).

2. At its meeting of 29 June 2009 the Code of Conduct Group (Business Taxation) “agreed that as regards common political understanding of the latest position in European law on anti - abuse and in particular what genuine economic activity means, the issue should be further examined in the Council's Working Party on Tax Questions (Direct Taxation), which would be invited to inform the Code of Conduct Group of the progress achieved. The Group reached consensus that anti-abuse examination should include inbound and outbound profit transfer and mismatches, in particular hybrid entities and profit participating loans, and that in order to assist this work of the Group a subgroup should be established” (doc. 10200/1/09 REV 1 FISC 69, par. 22).
3. At its meeting of 27 July 2009 the Council (GAERC) agreed, as a procedural decision taken by simple majority, to the establishment of a subgroup of the Code of Conduct Group to examine, with the view of establishing guidelines, anti-abuse issues related to inbound and outbound profit transfers and mismatches between tax systems, in particular as regards the treatment of hybrid entities and profit participating loans (doc. 11967/09 FISC 96).

PROGRESS OF WORK

4. The Code of Conduct Subgroup has met five times to discuss these topics: on 27 October 2009 under the Swedish Presidency and on 14 January 2010, 25 March 2010, 22 April and 12 May 2010 under the Spanish Presidency.

CONCLUSIONS

o Inbound profit transfers

5. The problem arises regarding inbound profit transfers entering the EU from non EU countries, whether directly to the Member State of receipt or through several Member States up to the Member State of receipt, when such income has not been taxed or it has been subject to tax at source at a low tax rate. There is a risk of abuse in this case, since the subsidiary resident in a third country will be able to avoid inbound taxation by using the most convenient Double Taxation Agreement (DTA). That income will afterwards freely flow within the EU with no withholding tax (under the Parent-Subsidiary Directive), arriving untaxed at final destination.

6. Two possible solutions were put forward:

a) An anti-abuse clause under the gatekeeper approach applied by all Member States - taxation by the inbound Member State when the income has been subject to a tax rate of less than 10%.

b) The improvement of exchange of information among Member States.
7. Having discussed in the Subgroup the principle that there should be limitations to the free inflow of no or low taxed income from third countries, consensus was not reached, but the majority of Member States preferred a mixed approach (gatekeeper + exchange of information) leading to the following guidance for the Code Group:

*As a minimum common guidance, profit distributions received by a corporate taxpayer from a third country subsidiary shall not be exempt from tax in the Member State, in which the corporate taxpayer receiving profit distributions directly from a third country subsidiary is resident, if they relate to income components that have been subject to a tax rate of less than 10%, unless that Member State operates anti-abuse provisions.*

*Where the above principle is not applied, the Member State, in which the corporate taxpayer receiving profit distributions directly from a third country subsidiary is resident, will exchange information in accordance with EU law provisions with the Member State of residence of the entity that holds an effective control in the corporate taxpayer in question.*

Some Member States consider that the income components should be limited to passive income.

The implementation of such guidance raises the question related to the consequences stemming from the use of the information exchanged by the Member State of residence of the parent company.

Not all Member States recognised that such an approach would produce an effective or acceptable solution and therefore maintained that it should not be required. Some Member States considered it the responsibility of Member States to combat this abuse through their own domestic anti-abuse rules consistent with the EU Treaty.
Outbound profit distributions

8. The problem arises regarding profit distributions from the EU to a third country (namely from a Member State in which a withholding tax is applied). It could be that by transferring the dividends to another Member State which does not apply such a withholding tax, the profit distribution remains untaxed, as under the Parent-Subsidiary Directive it can be transferred untaxed to the specific Member State, from which it can flow untaxed to a third country.

9. Two possible solutions were put forward:
   a) Approximation of rates and renegotiation of DTAs.
   b) Development of anti-abuse rules.

Upon reviewing concrete cases where this problem arises, one MS submitted a document about using the OECD concept of “beneficial owner” in the Parent-Subsidiary Directive, in a similar way as in the Interests and Royalties Directive.

10. Most Member States saw difficulties in applying the above mentioned solutions. Therefore, although some Member States recognised the problem concerning outbound dividends, it was not possible to find a satisfactory solution within the framework of the Code of Conduct.

Profit Participating Loans

11. Concerning profit participating loans the problem arises when the State of the corporate taxpayer paying interest allows its deduction from the tax base, whereas the Member State of the corporate taxpayer which receives the income considers it as a tax exempted dividend income; therefore, such income would remain untaxed in both Member States. It was acknowledged that there can be some other issues concerning mismatches, such as double taxation, hybrid companies or mismatches in national CFC rules.
12. Two possible solutions were put forward:

- The Member State receiving the loan and paying the interest, the source State, aligns with the tax treatment of the Member State of receipt, which would imply the denial of deduction of interest expenses,

- The Member State of receipt aligns with the tax treatment of the source Member State, which would imply to disallow the exemption of the payment received.

The second solution requires fewer Member States to modify their internal legislation.

13. Agreement was not reached, however all Member States but one uphold that solution and support the following guidance:

A hybrid loan arrangement is a financial instrument that has characteristics of both debt and equity. In as far as payments under a hybrid loan arrangement are qualified as a tax deductible expense for the debtor in the arrangement, Member States shall not exempt such payments as profit distributions under a participation exemption.

One Member State raised its fundamental reservations.