EU ADOPTS A PARENT-SUBSIDIARY DIRECTIVE AMENDMENT ON HYBRID LOANS

By Bertrand Dussert

On July 8th 2014, the European Union’s Economic and Financial Affairs Council (ECOFIN) adopted an amendment to the Parent-Subsidiary Directive (PSD). This amendment is targeted at cross-border hybrid loans and aims to neutralize the double non-taxation that may arise in those intra-group financing arrangements.

Originally adopted in 1990, the PSD was designed to eliminate tax obstacles to distributions of profit within EU groups of companies by (i) abolishing withholding tax on profit distributions by subsidiaries to their parents and (ii) eliminating double taxation on those profits. Member states are obliged to achieve these aims either by exempting from taxation the payments received or by granting a tax credit in respect of any foreign taxation suffered on the relevant profits.

1. The PSD loophole

The exemption method provided for under the PSD and widely used by the member states opens opportunities for tax arbitrage leading to double non-taxation by using hybrid instruments (i.e., instruments that are characterized differently under foreign and domestic tax laws).

These arrangements involve instruments that have debt-like and equity-like features; typically, cross-border profit-participating loans or convertible preference shares. As a result of the difference in tax treatment of such instruments, subsidiaries issuing such instruments can be treated as debt issuers while parent companies are simultaneously treated as equity holders. It follows that the subsequent interest/dividend payments are treated as deductible expenses in the state of the subsidiary while they are tax-exempt profit distributions, under the PSD, in the state of the parent.

On November 25th 2013, the European Commission issued a proposal to amend the PSD, including an anti-hybrid clause and a wider, general anti-avoidance rule (GAAR). This proposal was subsequently discussed by the ECOFIN Council on May 6th 2014; however, the required unanimity could not be reached since the Swedish and Maltese delegations raised concerns blocking an agreement on the proposal.

During the ECOFIN meeting of June 20th 2014, all member states agreed to the proposal to implement an anti-hybrid clause to the PSD but postponed the adoption of a GAAR.

2. The adopted PSD amendment

Under the adopted amendment, which modifies article 4(1)(a) of the PSD, the EU member state where the parent company is located shall “refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary.”
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This amendment, therefore, links the tax treatment in the state of the parent with that of the subsidiary. As such, the changes aimed at hybrid loan arrangements could affect certain group financing arrangements where such arrangements are not already limited under domestic rules. Indeed, many member states already have introduced broader anti-avoidance rules to tackle hybrid loan arrangements and/or already deny exemption for deductible distributions. The anti-hybrid measure may well make little difference in those member states.

All remaining member states will have to implement the new anti-hybrid rule within their domestic legislation by December 31st 2015, at the latest.

3. Wider implications: the end of inconsistency does not equal consistency

As the amended PSD stands, hybrid loan arrangements remain potentially attractive where a party to a hybrid arrangement is established outside of the EU and relies on its own domestic law for deduction or exemption. However, member states remain free to adopt anti-hybrid rules affecting non-EU parties. Notably, the United Kingdom, Germany and France have adopted provisions to that effect.

This does not mean this amendment is merely window-dressing, but rather that this is only a first step; the proposed GAAR will indeed, if adopted, harmonize EU anti-avoidance standards.

Taxpayers will nevertheless have to wait as the ECOFIN is only expected to resume its work on the GAAR in the forthcoming months. Further changes are also to be expected on a wider scale as part of the OECD’s BEPS action plan, which is under consultation until September 2014.

Considering the number and complexity of foreseeable changes, cross-border group financing arrangements should, more than ever, be carefully planned.

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