THE INTRODUCTION OF A MINIMUM EFFECTIVE TAXATION CLAUSE IN THE INTEREST AND ROYALTY DIRECTIVE

di Gabriele Colombaioni

The two Room Documents here commented take stock of the discussion and of the conclusions reached so far by the Council (at the relevant time led by the Dutch Presidency) about the proposal to modify the Interest and Royalty Directive (Directive 2003/49/EC, “IRD”) by the introduction of a “minimum effective taxation” (“MET”) clause. Such a proposal is being discussed alongside other actions that the Council, as well as other bodies of the EU, with a view to curb base erosion and profit shifting in the EU context and to keep pace with the work of the OECD in such area.

With particular reference to the MET clause, as summarised in the EU-BEPS Roadmap by the Netherlands Presidency of the Council (doc. 6039/16 FISC 20), a discussion on the potential changes to the IRD was already started under the Latvian Presidency and, at that point in time, concerned the introduction into the IRD of a “de minimis anti-abuse rule” similar to the one introduced into the Parent Subsidiary Directive (new articles 1(2) and 1(4) of the Directive 2011/96/EU). Given the difficulties found at reaching a political agreement on such a change, Member States (“MS”) decided, instead, to build on one of the elements of the recast proposal drafted by the European Commission in 2011 (COM(2011) 714 final, “recast proposal”), namely, the introduction of an “effectively subject to tax clause”. In the document EU-BEPS Roadmap by the Slovak Presidency of the Council of July 14, 2016 (doc. 11071/16, FISC 121), the Slovak Presidency has declared its intention to elaborate on the work done by the previous presidencies on the introduction of such a clause.

The rationale behind the introduction of an effectively subject to tax clause (like the one included in the recast proposal and the MET proposal currently discussed) is to make sure that interest and royalty payments are subject to tax once in a MS and that the provisions of the IRD are not improperly used to circumvent such minimum taxation (see par. 3 of 2011 (COM(2011) 714 final). In this respect, it is worth noticing that, compared to the recast proposal, the MET proposal goes a step further: where the recast proposal denied the IRD benefits only in the case in which the interests or royalties enjoyed an exemption in the MS of the recipient (see again par. 3 of 2011 (COM(2011) 714 final: “the recast amends Article 1 (1) in order to make it clear that Member States have to grant the benefits of the Directive only where the interest or royalty payment concerned is not exempt from corporate taxation in the hands of the beneficial owner in the Member State where it is established”), the MET proposal denies the exemption from WHT in the source MS if the recipient company is not subject to a certain minimum effective corporate income tax rate. In fact, as per the draft text attached to the Room Document #2, the new article 1 of the IRD would establish that the source MS would be obliged to exempt the interest or royalty payment from any withholding tax only if the payment at stake were “subject to an effective tax rate of a least 10% in the Member State of the beneficial owner”.
An interesting point of the MET proposal under analysis relates to the definition of “effective tax rate”. Threshold requirements based on effective tax rate criteria are usually used to determine the scope of application of CFC legislation and work by comparing the effective tax rate suffered by the CFC in its State of residence to the tax rate that such company would have suffered in the State of residence of its parent. The application of such a threshold requirement implies a case-by-case analysis to be undertaken in each financial year for each CFC and usually takes place in two phases:

(i) first, there must be a computation of the effective tax rate applied in the foreign jurisdiction. Such computation, in turn, requires a computation of the taxable income that the CFC would have been attributed under the tax provisions in force in the State of the parent. Then, the effective tax rate is obtained by a ratio of the tax actually paid in the CFC jurisdiction to the tax base previously computed;

(ii) second, the effective tax rate, as computed under (i), is compared to the benchmark tax rate provided by the threshold test in order to establish whether the CFC legislation shall be applied (such an approach has been described in par. 65-71 of the Final Report relevant to Action 3 of the BEPS project and, moreover, it has been endorsed by article 7(1)(b) of the recent Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market).

By comparison to the above model CFC rule some preliminary remarks on the MET proposal can be made.

First, the MET proposal makes clear that the effective tax rate shall be computed on the basis of the “isolated method” and, thus, as specified in Room Document #3, the computation shall take into account exclusively the taxation effectively borne by the interest and royalties in the jurisdiction of the recipient ignoring the effects of general losses incurred by the payee or the effect of any reduction not directly linked to that income. However, no definition of the relevant tax base is provided. The author is of the opinion that it would have been appropriate to include a codification of the rules applicable to compute the tax base suffered in the MS of the recipient directly into the provisions of the Directive, as the presence of an autonomous EU definition would foster a uniform application of the provision in all the EU MS. Conversely, in the absence of any indication, each MS could feel compelled to determine the interest or royalty tax base according to its own tax system, in particular with regard to the identification of the costs deductible. The risk of an uneven application of the rule is increased by the endorsement of the isolated approach, which requires EU MS to segregate the interest and royalty income from the remainder taxable income of the payee.

Second, it is not altogether clear whether the Council actually intended to introduce a case-by-case analysis, which is typical of effective tax rate threshold rules.

As per article 1a of the proposal, “the effective tax rate of a particular Member State shall be either the tax rate applicable under its general corporate income tax regime or the reduced statutory tax rate applicable under a special tax regime for interest or royalties, which ever is lower, taking into account any tax exemption,
special tax reduction, tax credit or tax refund applied in the tax period where the royalty or interest payment accrues”. Based on such definition, Room Document #3 breaks down EU MS in two categories:

(i) MS whose tax system does not provide for any special preferential tax regime for interest or royalties; and MS whose special tax regimes do not, in any case, lead to an effective tax rate lower than 10%;

(ii) MS that enacted a special tax regime for interests, or royalties, which provides for an effective tax rate lower than 10%.

According to the clarification provided in Room Document #3, recipient companies resident of MS falling under point 1 should automatically fall outside the scope of the MET clause and, thus, benefit from the IRD under the same circumstances applicable in the absence of such a MET clause. Room Document #3 further specifies that those companies should also not be subject to any additional compliance cost. The underlying rationale seems to be that “without a specific tax base or tax rate provision in place taxation will take place in line with the general tax system”. Moreover, considering that the 10% threshold equals the lowest general corporate tax rate in place in the EU (namely, that of Bulgaria), the 10% MET requirement would be met in each MS jurisdiction. In other words, it seems that the Council assumes that, in the absence of special regimes, MS jurisdictions are always able to provide for an effective taxation of interest and royalties of at least 10% without any need to undertake a case-by-case analysis. If correct, this reading would make irrelevant the differences existing among MS domestic rules concerning the ordinary deduction of costs from the interest and royalty gross income.

A computation of the effective tax rate levied in the MS of the payee would be required only for those recipients resident of MS which have in place special regimes for interest and royalty income. However, also in those cases, it seems that it is not the intention of the drafters to introduce a case-by-case analysis, which would call for a test on the effective tax rate applied on the interest and royalty income received by each payee in any given financial year. In this respect, Room Document #3 states that, for the purpose of calculating the effective tax rate, “the idea is not to estimate the effective tax rate on a transaction-by-transaction basis. In fact, the effective tax rate so calculated corresponds to the special regime as described and does not vary according to the particular circumstances of the individual transactions”. Based on this, it seems that the provision under discussion should be interpreted as focusing not on the effective tax de facto suffered by the payee but, rather, on the “effective” tax rate in abstracto granted by the special tax regime to any potential beneficiary (thus, for example, if the general corporate income tax in a given MS is equal to 19% and such MS enacts a special regime that provides for a 50% exemption for royalty income, companies benefitting from such regime should automatically fall outside the scope of the IRD without any need to check the effective levy suffered on the interest or royalty income).

In the author’s opinion, such interpretation seems furthermore supported by:
• the wording of article 1a of the proposal which, for the purposes of the computation of the relevant effective tax rate, states that reference shall be made to “the reduced statutory tax rate applicable under a special regime”;

• the fact that the Room Document #3 envisages an automatic exclusion, from the scope of the MET test, of MS companies benefitting of special regimes not providing for an effective tax rate lower than 10%.

Another interesting feature of the proposal relates to the coordination between the MET clause and patent box regimes. As stated in the Room Document #2, the Council acknowledges that MS should be granted “the possibility to provide companies effective tax incentive to invest in genuine R&D in the EU”. Coherently, the proposal envisages the possibility that companies benefitting from MS patent box regimes, which award an effective tax rate lower than 10%, could remain entitled to the application of the IRD. In this respect, the Council analyses two alternatives: (i) considering as compatible with the MET clause those regimes aligned with the modified nexus approach; and (ii) considering as compatible with the MET clause the regimes that, in addition to (i), also ensure a minimum level of taxation of the royalty income (to be identified).