Mr. Alexander Stubb
Minister of Finance

CC Terhi Järvikare, Director General of the Tax Department, Ministry of Finance
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12, April 2016

Subject: Recommendations on the Anti-Tax Avoidance Directive

Dear Minister of Finance Alexander Stubb

On the 28th of January, the European Commission released a set of measures to tackle tax avoidance within the EU and beyond. Such package includes the so-called Anti-Tax Avoidance Directive[1] (ATAD), a piece of legislation aiming at implementing key measures against base erosion and profit shifting in the EU. The solutions proposed are based largely on the OECD BEPS project recommendations, endorsed by the G20 leaders last year.

The European Union has now a unique opportunity to introduce effective anti-tax avoidance measures in all Member States. However, for the directive to really address the problem of corporate tax avoidance in the EU and globally, it needs to include ambitious measures going beyond the OECD BEPS proposals. Therefore, we call on you to support a strong ATAD and encourage other Member States to do the same.

We emphasize that the specificity of the European Union and its Single Market requires appropriate, strong measures, which might differ from the ones designed for individual states under the BEPS project. Furthermore, weak measures could actually encourage more tax competition between EU Member States. This would not only harm tax revenues in Europe, but would also have harmful spillover effects on developing countries which depend more heavily on corporate taxes.

In the context of current negotiations within the Economic and Financial Affairs Council configuration (ECOFIN), Finnwatch would like to highlight certain measures which we believe are crucial for tackling tax avoidance in the EU and in developing countries.

1 *Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, proposed by the European Commission on 28.01.2016*

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1. Strong **Controlled Foreign Companies (CFC) rules** are a crucial measure against profit-shifting into low-tax jurisdictions.

CFC rules (Articles 8 and 9 of the ATAD proposal) are key to addressing the problem of profit shifting to low-tax jurisdictions and an important backstop for the efforts of developing countries to curb tax avoidance, as they also provide a disincentive for shifting profits from developing countries.

For CFC rules to be effective, we draw your attention on the following issues:

- **CFC rules should be mechanical and easy to implement.**

  Current discussions at Council level tend to deviate from such principle as the treatment of the tax base of a taxpayer is left to the choice of Member States. One option in particular proposes to only include non-distributed CFC income resulting from non-genuine arrangements that serve the purpose of achieving a tax advantage. This would be highly ineffective as non-genuine arrangements and their purposes are hard to prove and their identification requires significant human resources from tax administrations.

  <u>Our recommendation:</u> CFC income should be included in the tax base of a taxpayer as proposed by the European Commission on Article 8 §1 (c). To accommodate concerns about unintended effects on real business activities, an escape clause can be implemented that allows a firm to prove that CFC income results from real business activities and does not include profits shifted out of other countries.

- **CFC rules have a deterrent effect with a high relative threshold tax rate or a fixed threshold tax rate**.

  The European Commission rightly proposes to link CFC rules to the effective tax rate of the country where the CFC is located. Indeed CFC rules are aimed at taxing income which has been artificially shifted to low or zero tax rate jurisdictions. However, 40% of the effective tax rate in the Member State as proposed in the current draft directive is far too low and risks encouraging still more tax competition, as tax-aggressive firms might choose to re-locate their parent companies to Member States with a lower tax rate.

  <u>Our recommendation:</u> If the rule is to have any meaningful effect, the threshold must be set at a significantly higher percentage or at a sufficiently high fixed rate (as it is currently the case in some of the Member States' CFC regulations). By way of illustration, we note the OECD's observation that many countries use a benchmark of 75 per cent of their statutory tax rate to trigger CFC rules.

- **CFC rules should apply to the income of a CFC regardless of whether it is distributed or not.**

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The current proposal limits CFC rules to non-distributed income. Distributed income may be covered by the switchover clause in Article 6 of the draft directive, depending on type of income and foreign tax regime. Article 9(5) contains a necessary provision to prevent double taxation of CFC income under both CFC rules and the switchover clause. Apparently, there is an implicit assumption that CFC income can only be distributed after the end of a financial year, and thus after it has been subject to CFC rules. However, this might create opportunities for avoidance of CFC rules, for example through interim dividends. The directive should be explicit that CFC rules apply regardless of whether and when the income is distributed.

Our recommendation: Amend Article 8 by deleting *non-distributed* from the definition of relevant entity income.

2. **Anti-inversion clause**

To address any concerns that strong CFC rules might lead to EU companies deciding to artificially relocate their headquarters outside of Europe, an anti-inversion clause could be introduced in the ATAD.

Our recommendation: Introduce an anti-inversion clause and enable a place of effective management test to decide where the parent of the CFC is considered resident.

3. Rules against **hybrid mismatches** can benefit both EU and developing countries

Rules against hybrid mismatches can benefit developing countries by making it more difficult to shift profits out of their territory and into the EU in such a way that profits remain untaxed. However, the OECD's BEPS proposals relating to hybrid mismatches are insufficient. The current proposal (Articles 10 of the draft ATAD) only covers hybrid mismatches between EU member states. This makes it very weak, as mismatches between a Member State and a third country are also common.

Our recommendation: The directive must also contain rules against hybrid mismatches between a Member State and a third country

4. **Interest limitation rules** are an important mechanism against artificial profit shifting

The proposed limitation is the top end of the range of 10–30 per cent of EBITDA proposed in the OECD BEPS recommendations. Given the well-documented abuse of interest deductions, which is also a major concern for developing countries, the limitation should be set at 10 per cent (with a group escape). This would help to establish a more effective international standard.

Our recommendation: Amend Article 4 by lowering the 30% deductions limit to 10%.

Finland has an opportunity to lead by example in the pursuit of tax justice, and to respond convincingly to public outrage against corporate tax dodging. This requires the adoption of strong and effective legislation which also addresses problems with EU tax rules impeding the efforts of developing countries to raise more of their own revenues for sustainable development.

We therefore urge you to push for the adoption of a robust legislation which includes the measures recommended above at next Economic and Financial Affairs Council.

We remain at your disposal if you would like to receive more information or would like to meet in person to discuss this issue further. We also very much welcome your response to our recommendations.

Sincerely,

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