EU amending Parent-Subsidiary Directive to address hybrid loan arrangements

July 16, 2014

In brief

The European Union's (EU) 28 Finance Ministers agreed, on June 20, 2014, to amend the EU's Parent – Subsidiary Directive (Directive), addressing the effects of tax arbitrage resulting from EU Member States' varying tax treatments of hybrid loans. The Directive aims to exempt from withholding taxes profit distributions (e.g., dividends) paid by subsidiaries to their parent companies, thus eliminating double taxation of those distributions at the parent company level.

The Member States have now agreed that the Directive's benefits should not result in 'double non-taxation,' that is, income going untaxed by any jurisdiction and thus generating unintended tax benefits. The EU's concern is that such tax arbitrage could result in groups of companies that operate in multiple Member States enjoying more favorable overall income tax treatment than groups of companies that operate only in a single Member State, where such distributions may be subject to tax.

In detail

Under the amended Directive Article 4.1 (a), the Member State of the parent company (or its permanent establishment) receiving the distribution will be required to "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...." This amendment is based on a November 2013 European Commission (Commission) proposal.

Following the political agreement in the EU's Economic and Financial Affairs Council (ECOFIN) (and subsequent linguistic and legal finalization of the text), a forthcoming European Council session will adopt amended Article 4.1 (a). Member States will have until December 31, 2015 to adopt this revised rule into local law.

In an accompanying statement (added to the ECOFIN conclusions), the Commission:

- stresses that the amended Directive Article 4.1 (a) will apply where differences between Member States in the tax treatment of profit distributions from subsidiaries to parent companies result in 'double non-taxation' and unintended tax benefits
- confirms that the amended Article 4.1 (a) is not intended to apply where no 'double non-taxation' occurs or where its application would result in double taxation of profit distributions
- confirms that adopting this proposal does not oblige Member States to

adopt any future legislative proposals in the field of direct taxation

The Commission had also proposed to replace the Directive's current anti-abuse provision with a common general anti-avoidance rule (GAAR), based on its December 6, 2012 Aggressive Tax Planning recommendation to EU Member States. This proposal will be discussed further under the incoming Italian rotating EU Council Presidency.

The takeaway

This Directive amendment will affect certain hybrid instruments used by multinationals with holding companies in certain European countries, although it does not mandate how the income from such instruments must be taxed. The new rule applies to intra-EU hybrid instruments, such as Profit-Participating Loans (PPLs) and Obligations Remboursables en Actions (ORAs), but not hybrid instruments between EU and non-EU entities, such as Convertible Preferred Equity Certificates (CPECs). The amendment addresses an aspect of the 'hybrid mismatch arrangements' that the Organization for Economic Cooperation and Development (OECD) deals with in its Base Erosion and Profit Shifting (BEPS) initiative.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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