# EU BEPS / Taxing Low-Taxed Non-EU Income: Think Twice…

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**(about the switch-over clause in the ATA Directive)**

In order to combat BEPS, the European Commission is proposing to start taxing low taxed non-EU income. That sounds reasonable, but the consequence will be that in the EU, there will be no more profits to tax. This is a proposal that is not necessary to prevent BEPS, will lead to a (tax rate) race to the bottom in the EU and will be devastating for employment and the economic power of the EU.

On 28 January 2016, the European Commission published an Anti Tax Avoidance Package containing measures to address aggressive tax planning and increase tax transparency. An important part of that package is a proposal for an Anti-Tax Avoidance Directive (ATA Directive). With the ATA Directive, the EU is trying to implement EU measures against BEPS. The plan is that the EU Council will approve it as soon as this summer. Professor Werner Haslehner has already published a quick scan of the proposal on this blog.

The general goal of the ATA Directive is to have an effective taxation on corporate profits. The Directive tries to ensure that 'tax is paid where profits and value are generated'. For this, the ATA Directive introduces a 'common framework [which] could prevent a fragmentation of the market and put an end to currently existing mismatches and market distortions'. It is important that the ATA Directive does not regulate the prevention of the avoidance of corporate tax in detail: 'As the rules would have to fit in 28 separate corporate tax systems, they should be limited to general provisions and leave the implementation to Member States as they are better placed to shape the specific elements of those rules in a way that fits best their corporate tax systems’. The directive sets a ‘common minimum level of protection for the internal market in specific fields’.

In order to accomplish an effective taxation on corporate profits in the EU, the EU would do best to introduce a Common Corporate Tax Base (CCTB). Only with one tax base, the EU can ensure that an effective taxation is possible. The EU could then also see to it that besides effective taxation on corporate profits, the EU would continue to be attractive for foreign investors. By designing a carefully balanced EU corporate tax system with special facilities which stimulate, for example, Research & Development, the EU could attract the Ubers and AirBNBs of this world to the EU. Because, think of this: “no investment, no profits”, and, consequently, nothing to tax. Such a (balanced) proposal is on its way: the EU CCTB is to be presented by the Commission later this year.

But it has not come to that yet: at this moment, the EU wants to build on the momentum: Internationally, combating tax avoidance is high on the political agenda and must thus be tackled now. The ATA Directive only contains anti-tax avoidance measures; the measures which are to act as stimulants for investments in the EU are to come later.

I hear you think: is that a problem? Measures against tax avoidance must be applauded, so the faster they are implemented the better.

A closer look at the ATA Directive, however, shows that this proposal is not restricted to measures which combat real tax avoidance. The directive is not always restricted to situations which are wholly artificial and non-genuine. Well, there is nothing against using more general anti-abuse measures against BEPS, but there must be an underlying policy on this, given that such more general anti-abuse measure can also affect normal business activities.

A measure of the ATA Directive which – in my view – may have a detrimental effect on genuine business activities is the proposal for a switch-over clause.

At present, many EU Member States exempt from taxation dividends on shares in foreign subsidiaries, or exempt profits of foreign permanent establishments. According to the proposal, it is 'the unintended negative effect of this approach (…) that it encourages situations whereby untaxed or low-taxed income enters the internal market and then, circulates – in many cases, untaxed – within the Union, making use of available instruments within the Union law'. For this reason, the ATA Directive proposes to deny an exemption from corporate tax with respect to foreign non-EU dividend from shares or for profits of non-EU foreign permanent establishments which are taxed against a statutory tax rate which is too low. Too low is a tax on profits at a statutory corporate tax rate lower than 40% of the statutory tax rate that would have been charged under the applicable corporate tax systems in the EU Member State of the taxpayer. This is the so-called switch-over clause: the exemption system will switch-over to a credit system for the tax paid abroad. The advantage of the low tax regime is thus taxed away in the EU.

With the switch-over clause, the EU is imposing its corporate statutory tax rates on the rest of the world. The EU plays the role of global referee punishing non-EU countries with statutory tax rates that are significantly lower than an EU Member States statutory tax rate. European enterprises that wish to expand on non-EU markets would be put at a competitive disadvantage: There where the local competitor can profit from the local lower tax rate, the tax advantage is taxed away in the EU for local enterprises with EU owners. Enterprises with EU owners would thus be put at a disadvantage in the non-EU country. This effect of a credit system, also called "capital export neutrality" in the economic literature, is generally considered in the EU as being bad for the internal market.

Foreign active enterprises will be taxed more heavily compared with domestic enterprises, this is bad for an open market. Many Scholars, such as German professor Klaus Vogel (in the eighties) and Amsterdam professor Wattel, have always advised against the credit method in an EU context. Also the famous Ruding report from 1992 (about company taxation in the EU) favoured the exemption method in the EU. In practice, we have also seen that first the smaller EU Member States (the Netherlands, Ireland, Belgium), then later also the larger Member States (Spain, the UK, France) introduced an exemption system instead of credit systems. Are we now going back to "square one"?

In a globalised world, the competition outside of the EU is increasingly important. Putting EU enterprises at a potential disadvantage when expanding business in the rest of the world, seems very strange indeed. I re-iterate: the switch-over clause is also applicable to genuine business activities conducted by EU owners in the rest of the world. For example, when EU enterprises make use of a special tax rate in a special economic zone in China. EU enterprises will no longer be able to make optimum use of those special zones due to the switch-over clause, but their Chinese and other non-EU competitors will.

Moreover, what in fact is the real reason for the switch-over clause? The Directive speaks of 'the unintended negative effect of' the exemption for foreign income. Is there really an 'unintended negative effect'? I do not think so; the exemption system has nothing to do with profit shifting (a switch-over clause is not even proposed in the OECD BEPS project), and there is nothing negative about the flow of previously taxed genuine business profits through the EU. Because let us be clear, the EU has no power to levy tax on the non-EU foreign income; that power lies there "where the profits and the value are created": thus, in the non-EU country. Not in the EU. And this is exactly the OECD BEPS "mantra": the State where the profits and value are created has the power to tax.

If the EU is to act as referee of the world where it concerns what corporate tax rate must be considered a minimum effective taxation of genuine business activities, then I predict that in practice, the headquarters of the multinationals will go to the EU Member State with the lowest statutory tax rate (Ireland), so it will stimulate a race to the bottom in the EU. Or, the headquarters of multinationals will leave the EU. They will settle in jurisdictions such as Switzerland which, as always, takes a neutral stance. Once those headquarters start leaving the EU, there will less and less foreign income to tax at all in the EU. Less profit, less tax, less jobs. The effect of the switch-over clause can have serious negative consequences for the EU's economic climate. It is therefore remarkable that the Commission did not prepare any impact assessment of the measure conducted.

My advice is simple: delete the switch-over clause. The ATA Directive must restrict itself to real BEPS situations, or wholly artificial arrangements. That is the way for the EU taking a leading role in the entire BEPS project.

Furthermore, the ATA Directive already contains Controlled Foreign Company legislation which tackles more specific passive low taxed entities. This CFC legislation can be much better defended because it only affects low taxed passive and mobile income. So it is targeted to prevent profit shifting.

The EU, thus, does not need the general switch-over clause at all. If this clause is thoughtlessly introduced regardless, it could cost the EU economic power. So think twice.