

Baker Tilly in South East Europe

Cyprus, Bulgaria, Greece, Romania, Moldova

Tax changes in Romania and internationally affecting substance

Exchange of Information by banks

March 2017

Agenda

- Changes in the Romanian and international tax scene make substance an important element of operating internationally
- The EU and OECD environment
- Substance requirements
- Implementation of automatic exchange of information by banks and other financial institutions and common reporting standard

Changes in the Romanian and international tax scene affecting businesses

Changes affecting substance

- Stricter application of domestic law and tax compliance requirements
- EU initiatives that Romania has to enforce as an EU member state
- OECD BEPS initiatives which Romania has committed to adopt and implement in its domestic legislation
- OECD initiatives on tax transparency through the Global Tax Forum and the Common Reporting Standard

EU Initiatives

EU Initiatives

- Amendment to the EU Parent / Subsidiary Directive which effectively (subject to certain conditions) exempts from taxation dividends paid by a company located in one member state to a company located in another member state.
- Adoption of the EU Anti - Tax Avoidance Directive, which will address transactions between companies located in different EU member states.

EU Parent / Subsidiary Directive: anti-abuse clause (1)

- The EU Council amended the EU directive with the aim of preventing tax avoidance through the use of the so called “hybrid instruments” and the use of aggressive tax planning by corporate groups.
- The anti-abuse clause is aimed at preventing misuses of the directive and ensuring a greater consistency in its application in different member states. It requires governments to refrain from granting the benefits of the parent / subsidiary directive to an arrangement, or a series of arrangements, that are not "genuine" and have been put in place to obtain a tax advantage, while not reflecting economic reality.

EU Parent / Subsidiary Directive: anti - abuse clause (2)

- An arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.
- Where arrangements or a series thereof are ignored, the tax liability shall be calculated in accordance with national law.

EU Anti - Tax Avoidance Directive

- The directive was adopted at a meeting of the EU Economic and Financial Affairs Council (ECOFIN) in June 2016.
- Member states (including Romania) have until **31 December 2018** to transpose it into their national laws and regulations, except for the exit taxation rules, for which they will have until **31 December 2019**.

EU Anti-Tax Avoidance Directive –



Issues addressed

- **Limitation of interest costs** – deductibility of intergroup interest costs will be restricted upto a maximum percentage of EBITDA
- **Imposition of exit taxation** – in cases where a company tax resident in one member state moves its tax residency to another member state
- **General anti-abuse rules** – will restrict access to directives
- **Controlled Foreign Corporation (CFC) rules** – profits of foreign subsidiaries may be taxed even when there is no actual dividend distribution
- **Hybrid mismatches** – in order to avoid double non - taxation

OECD Base Erosion Profits Sharing ("BEPS")

Base Erosion Profits Shifting (BEPS)

The initiative is aimed at dealing with issues of fair allocation of profits between companies located in different countries based on added value and risk assumption.

Actions include:

- Counter harmful tax practices
- Prevent treaty abuse
- Transfer pricing

BEPS - Action 5

Counter harmful tax practices more effectively, taking into account transparency and substance

- Substantial activity requirement in the case of exploitation of intangibles (IP Box Regime), so that benefits will only be granted only when the IP (strictly defined) is developed by the company itself. Using third parties is allowed whereas transactions with related parties will not qualify
- Framework for improving transparency in relation to rulings, so that ruling issued by the tax authorities granting special treatment or concessions is notified to all countries affected by the said transactions

BEPS - Action 6 (1)

- The action identifies treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns.
- Taxpayers engaged in treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving countries of tax revenues.
- Treaty shopping generally means that a person tax resident in Country A wants to invest in Country B and for doing so he establishes a company in Country C which invests in Country B, because Country C has a double tax treaty with Country B (Country A has no double tax treaty with Country B) or the treaty between Country B and Country C as compared with the treaty between Country A and Country B

BEPS Action 6 (2)

- It should be expected that once the multilateral instrument amending the double tax treaties (“DTTs”) is adopted by the OECD, Romania will ratify the instrument, which effectively would mean that double tax treaties that Romania has entered into with countries (which also ratify the instrument) will be considered as automatically including the LOB provisions
- Companies using the double tax treaty network need to introduce changes to their existing structures in order to take into account this limitation of benefits provisions, otherwise they will lose their tax treaty benefits

Action 15 –Multilateral Instrument (1)

- The Multi-Lateral Instrument (“MLI”) will only apply to DTTs in cases where both States are party to the MLI. The MLI will not impact any DTTs where only one of the Contracting States is a party to it
- The MIL has been adopted by the countries at the end of November 2016 and it is expected to be signed formally in June 2017
- It is anticipated that the effects of the MLI would be felt in 2018 or 2019, depending on the time of the adoption of the MLI by the respective countries

Substance Requirements

Substance Requirements

- New rules on substance in the new EU Parent / Subsidiary Directive
- Rules under EU Commission's anti-tax avoidance directive
- Substance rules under OECD's Base Erosion and Profit Shifting (BEPS) Action Plan
- Rules on tax residency in Greece

Substance would determine the company's tax residency (1)

- Substance can start from the minimum which is statutory substance. Statutory substance is to prove that the company is actually a real company and not a conduit, by paying its taxes, filing its tax returns, preparing audited financial statements and meeting all its statutory obligations.

Substance would determine the company's tax residency (2)

- Statutory substance is the minimum substance contained in the domestic law
- Physical substance is statutory substance plus an office, telephone facilities, employees and properly qualified directors.
- Economic substance refers to more on day to day activities, which is a similar concept to effective management.

Holding Company – pure holding activities vs multi- activities?

- The holding company SPV is no longer a preferred solution
- Taking into account any business risks / considerations (if any), a company, in addition to its holding activities, it could provide financing to group companies, license intangibles, provide services and carry out trading activities
- This would substantiate a claim that there are various business reasons for the existence and operation of the company

Holding company – standalone SPV vs multiple investments?

If an investor in Country A injects equity/grants loans into a holding company in Country B, which in turn creates a subsidiary in Country C (instead of the investor in Country A investing directly in the company in Country C), it is obvious that the main/one of the main objectives of the investor was to take advantage of a tax treaty/directive benefits of the specific country (which he could not obtain by investing directly from his own country)

Holding company – standalone SPV vs multiple investments? (2)

If, instead, the holding company in Country B invests in a number of subsidiaries in various countries, then it is becoming difficult for a tax administration to claim that the structure was put in place with the only purpose of obtaining benefit under the specific tax treaty/directive

Holding Company – economic motives necessary?

- Economic motives in addition to taxation motives become increasingly important
- In the case of Cyprus, these motives could be operational costs, banking system, company law flexibility, location of the country, availability of staff, cultural relationships etc
- Combining economic motives with tax motives is still not a crime

Holding Company - headquarters in a domiciliation company?

- A question which needs to be addressed is whether a pure holding company with headquarters in a country like Cyprus and with little activities within Cyprus can withstand the international pressure for taxation and substance
- The holding company needs to demonstrate that its board of directors are qualified and experienced enough in the specific industry, capable enough and with adequate time available in order to spend on making proper informed decisions on the investment activities of the company.
- ***Is it necessary for holding company to have fully operational offices with a large number of employees?***

Holding Company – Level of substance (a tribunal’s view)

In so far as either entity is no more than a holding company, or a company with little or no day-to-day operational activities, ***its day-to-day “management” will necessarily be very limited, and so will its physical links with its corporate seat.*** Put another way, ***it would be entirely unreasonable to expect a mere holding company, or a company with little or no operational responsibility, to maintain extensive offices or workforce, or to be able to provide evidence of extensive activities, at its corporate location.***

Implementation of Automatic Exchange of Information by banks and other financial institutions and the CRS

Automatic Exchange of Financial Account Information on Tax Matters and the CRS



- The Standard for Automatic Exchange of Financial Account Information on Tax Matters and the Common Reporting Standard (CRS) has been adopted by 101 countries (54 implementing on 1 January 2017 and 47 countries starting as from 1 January 2018)
- All EU countries will report in 2017, except Austria which will report as from 2018.
- Other countries to report as from 2018 include Australia, Canada, Israel, Japan, Russia, Singapore, Switzerland and UAE.

CRS – Financial Institutions

This standard covers Financial Institutions (“FI”) resident in the state or a branch in the state of a foreign resident FI.

These are classified as:

- **Depository Institution (banks)**
- **Investment Entity**
- **Custodial Institution**
- **Specified Insurance Company**

CRS – Reportable persons

- An individual tax resident in the other state
- An entity (including funds and foundations) tax resident in the other state
- There is a requirement to look through passive entities in order to find out and report on the controlling persons who are tax resident in another state
- It excludes publicly listed companies and Financial Institutions

CRS - Active NFE / Passive NFE (1)

Active Non – Financial Entity (NFE) is:

An entity which operates an active trade or business other than that of a financial business and meets any of the following criteria:

- Less than 50% of preceding calendar year's gross income is passive income AND less than 50% of the assets held during the preceding year are assets that produce or are held for the production of passive income

CRS - Active NFE / Passive NFE (2)

Active Non – Financial Entity (NFE) is:

- The stock of the NFE is regularly traded on the stock exchange or related to an entity regularly traded on a stock exchange
- Substantially all the activities consist of holding (in whole or in part) share capital or providing financing and services to one or more subsidiaries which engage in trades or business other than the business of FI, not including investment funds (private equity fund, venture capital fund etc.)

CRS – Controlling persons

- **For companies** - the UBO who is the natural person who ultimately owns or controls a legal entity through direct or indirect ownership meaning:
 - (i) 25% + of shares with voting rights
 - (ii) right to appoint board members, right to exercise significant influence
- **For unions, administrative committees, foundations, clubs, associations** – the members of the board of directors/committee or the administrators
- **For trusts** – the settlor, trustees, the protectors, the beneficiaries and any other natural persons exercising ultimate effective control over the trust.

Example of CRS reporting

A Romanian tax resident company (Active NFE) owned by a Greek tax resident individual has bank accounts with a Cypriot bank with a total balance at 31.12.2016 of Euro 300.000.

The Cypriot tax authorities will report the information to the Romanian tax authorities only

A Romanian tax resident company (Passive NFE) owned by a Greek tax resident individual has bank accounts with a Cypriot bank with a balance at 31.12.2016 of Euro 300.000

The Cypriot tax authorities will report the information both to the Romanian and the Greek tax authorities

CRS – Reportable information

Account balances or values at the end of the year (or in case account was closed during the year the balance on the date of closure), plus:

- Custodial accounts - gross amount interest, gross amount of dividends, the total gross amount of other income generated with respect to assets held in the account and the total gross proceeds from the sale or redemption of financial assets paid or credited to the account during the reporting period
- Depository (bank) accounts - Gross amount of interest paid or credited during the reporting period
- Income from certain insurance products

CRS – Reporting deadlines

The first exchange of information in relation to new accounts and pre-existing individual high value accounts will take place by the end of September 2017 (2016 information).

Practical steps for CRS

- Romania, Bulgaria, Greece and Cyprus are early adopters of the CRS and will start exchanging information as from 2017
- The identification of the country of tax residency of individuals and companies is made on a self-certification form
- In the case of legal entities, the banks may exclude accounts which in total are upto US\$250.000 at 31 December 2016 or in any subsequent year
- In 2017 the exchange of information will be done by Romania, Bulgaria, Greece and Cyprus only with those countries which are also early adopters

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