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ATOZ ALERT

European Commission wants a unified tax rulebook for companies: is it realistic?

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On 19 May 2021, the European Commission released a Communication, "Business taxation for the 21st Century", which sets out both a short-term and a long-term vision, ostensibly to support Europe's recovery from the COVID-19 pandemic and ensure adequate public revenues over the coming years. One of the biggest and most ambitious proposals included in the Communication is the "Business in Europe: Framework for Income Taxation" ("**BEFIT**") which the Commission intends to present by 2023. BEFIT would introduce new corporate tax rules applicable in all EU Member States for determining the corporate tax base of companies and allocating their profits among the EU Member States. BEFIT would also allow groups to file one single EU tax return. In the shorter term, the European Commission intends to present a proposal for the publication of effective tax rates paid by large companies, EU rules to neutralise the misuse of shell entities for tax purposes, recommendations on the domestic treatment of losses and a proposal creating a Debt Equity Bias Reduction Allowance. That's a lot for one communication!

We will review some of these proposals in this alert. While some of them may potentially come through and be implemented in the future, we anticipate a lot of issues and challenges regarding the introduction of a single set of direct tax rules which would apply all over the EU, as this amounts to a frontal assault on Member State tax sovereignty. In addition, while the proposals are presented as being aligned with the current developments at OECD level, in fact they seem to diverge in a number of ways, creating another source of tension.

It is worth noting that the business taxation proposals are placed within an overall context that raises important and interesting questions such as the appropriate tax mix (labour/ business/ capital property...) and other critical areas of taxation such as the Carbon Border Adjustment Mechanism (CBAM). In our view, these may ultimately be far more significant than the actions in the field of business taxation that are proposed in the communication.

BEFIT (Business in Europe: Framework for Income Taxation)

The European Commission presents BEFIT as a way to move towards a common EU tax rulebook and provide for a fairer allocation of taxing rights between Member States. The proposal which goes beyond the agreement to be reached at OECD level on the so-called Pillar 1 (partial re-allocation of taxing rights) and Pillar 2 (minimum effective taxation of multinationals' profits) strongly resembles the previous Common Consolidated Corporate Tax Base ("**CCCTB**") proposal, which will be withdrawn, and has some common features with Pillar 1 developments at OECD level.

BEFIT would be a single corporate tax rulebook for the EU, based on the key features of a common tax base and the allocation of profits between Member States based on a formula (formulary apportionment). It would build on the progress achieved in the discussions at OECD level, where these concepts are already present, through the use of a formula for the partial reallocation of profits under Pillar 1 and common rules for calculating the tax base for the purposes of applying Pillar 2. BEFIT would consolidate the profits of the EU members of a multinational group into a single tax base, which would then be allocated to Member States using a formula, to be taxed at national corporate income tax rates. Key considerations would include how to give appropriate weight to sales by destination, to reflect the importance of the market where a multinational group does business, as well as how assets (including intangibles) and labour (personnel and salaries) should be reflected, to ensure a balanced distribution of corporate tax revenue across EU Member States with different economic profiles.

According to the Commission, BEFIT would "ensure that businesses in the Single Market can operate without any undue tax barriers and would ensure that the existence of mismatches between corporate tax systems in the EU does not undermine the ability of Member States to raise revenue to fund national spending priorities." It would "deliver substantial simplification for groups of companies operating in the Single market. It would also pave the way for even further administrative simplifications, such as the possibility of a single EU corporate tax return for a group. The use of a formula to allocate profits will remove the need for the application of complex transfer pricing rules within the EU for the companies within scope. Through a combination of formulary apportionment with a common rulebook for the tax base, BEFIT will mark an important step in building a more robust business tax system in the Single market."

While the principles of a common tax base and of formulary apportionment already featured in the previous CCCTB proposal, the new proposal would reflect the significant changes in the economy and in the international framework since March 2011 when the CCCTB was originally proposed. Most notably, it would "seek to build on the approach taken in the forthcoming global agreement in its proposals for the definition of the tax base and also feature a different apportionment formula, which would better reflect the realities of today's economy and global developments, in particular by taking better account of digitalisation", according to the Commission.

The Communication does not provide any details on the companies which would be in the scope of BEFIT. However, several statements in the Communication make it clear that some companies would be in the scope of the new provisions while some would not. However, will it be a scope defined based on whether the company has cross-border activities within the EU or not only? Or will it be defined based on the size or level of turnover of the company/group? Or will it be a scope in line with what will be defined at OECD level under Pillar 1 once a final agreement has been reached? Current OECD thinking is that only a small number of the largest global companies would be subject to formulary profit apportionment under Pillar 1. The reasoning is that the complexity involved means the apportionment system should only apply where really necessary and where there is a large amount at stake. The Commission proposals suggest that the EU rules on formulary apportionment would also apply to SMEs and postulate that the system brings simplicity, not more complication, which is hard to square with the current OECD consensus. A lot of questions, which remain to be answered, and the scope of application is one of the issues that BEFIT would create: on the one hand, limiting the scope of new rules may make sense as it is important to only make changes where a real need can be identified. On the other hand, having two different tax systems applying in parallel can also be very problematic because it means that a company may be subject to one tax system or the other, depending on how its business is performing (if a certain threshold in terms of size or turnover is reached) and the tax system applicable to this company may change from one year to another.

Without knowing the scope of application of the new rules, it is quite difficult to assess their potential impact and their chance of succeeding. However, what is already quite clear is that the BEFIT proposal has the potential of becoming a clear threat to the national sovereignty of the Member States. Should such proposal be adopted, the room for manoeuvre of Member States in corporate tax matters would be reduced drastically, especially if the scope of application of the BEFIT rules is broad. Tax is a key aspect of national sovereignty as tax revenues provide governments with the means they need to function and tax laws reflect the structure of economies and the choices made in terms of tax policy.

One limit which EU Member States have to take into account when they adopt tax legislation is the respect of the EU fundamental freedoms. The European Commission can also take action if there is a need to make the internal market work properly. However, BEFIT seems to go far beyond those limits and it is questionable whether performing such a huge tax reform at EU level at this point is really justified.

We have to keep in mind that at the time the original CCCTB proposal emerged, no real action had been taken yet, neither at global level, nor at EU level, to fight against base erosion and profit shifting. Thus the CCCTB proposal potentially had value as a tool in the fight as against aggressive tax avoidance. Now, the situation is totally different: 15 BEPS Actions have been adopted at OECD level and with its Anti-Tax Avoidance Directives ("**ATAD**") 1 & 2, the EU has implemented these measures and sometimes even went beyond them by making some of the OECD recommendations become minimum standards for EU Member States. Finally, huge improvements have been made to improve tax transparency through the various amendments of the Directive on Administrative Cooperation ("**DAC**" 1-7). The scope for BEFIT bringing benefits in the fight against aggressive tax avoidance seems very limited therefore and it looks like a very blunt tool in this regard.

It remains to be seen therefore how the Governments of the various Member States will react to BEFIT, since firstly the project looks very much like a remake of the CCCTB, which Member States never managed to agree on and secondly international developments in the ten years since the CCCTB first emerged have removed much of its original purpose.

Publication of the effective tax rates paid by large companies

The second proposal announced is expected to be presented next year and would introduce an annual publication of the effective corporate tax rate of certain large companies with operations in the EU, using the methodology agreed for the Pillar 2 calculations.

With this proposal, the European Commission would like to make available to the public information regarding the proportion of corporate tax paid by companies relative to the amount of profits they generate rather than relative to their 'taxable profits', which can be reduced through various means. According to the Commission, the proposal will improve public transparency around the real effective tax rate experienced by large EU companies.

Here, we can expect the same discussions among EU Member States as over the past years in respect of the proposed directive on public country-by-country reporting (public "**CbCR**"), which, more than 5 years after it was presented, has not yet been adopted. As a reminder, the public CbCR is a tool which would require large MNEs to publish a defined set of facts and figures currently provided to the tax authorities, thereby providing the public with a global picture of the taxes MNEs pay on their corporate income. This tool has been criticised on many occasions because it provides private information to the public and the media which is already at the disposal of the tax authorities and thus is not a means to fight against tax avoidance but more a means to show the public and the media how "fair" or "unfair" taxation is. In addition, in the recent political discussions on CbCR two strong objections still need to be addressed, firstly the competitive disadvantage created for European headquartered MNEs compared to their non-EU competitors and secondly, how any attempt to redress this disadvantage by forcing non-EU MNEs to publish similar information can be squared with international agreements and extra-territorial concerns.

EU rules to neutralise the misuse of shell entities for tax purposes

Another proposal of the European Commission will be presented by the end of this year and aims to tackle entities and structures created for the main purpose of reducing the tax liability or disguising improper conduct of the group or operations they belong to, without substance and real economic activities in the countries where they are incorporated.

The proposal will include a requirement to report the necessary information to the tax administration to assess whether companies have substantial presence and real economic activity, denying tax benefits linked to the existence or the use of abusive shell companies, and creating new tax information, monitoring and tax transparency requirements to ensure these rules are functioning and enforced.

It is not immediately obvious that companies that are abusive would not be already covered by the general anti abuse provision in ATAD 1 and what information on the substance of companies is not already available in the corporate tax returns of these companies. However, in the current political climate, there seems to be an unquestioned assumption that more information and reporting is always good, so this proposal has quite a good chance of succeeding even in the absence of any proof that it is necessary or effective.

The Commission also intends to take further steps to prevent royalty and interest payments leaving the EU from escaping taxation. This gets a passing mention as part of the shell entities action, without any detail. While superficially attractive as a proposal, it seems difficult to imagine that a bond issued by a European company will give rise to non-deductible interest or withholding tax if held by a US pension fund, but not if the bond is owned by a European pension fund.

Domestic treatment of losses

The European Commission notices that because of a more limited cash flow, SMEs are often less able to absorb or finance losses than larger companies and this is why many Member States have acted quickly during the current crisis to relieve the immediate tax burden on SMEs, for example via a deferral of tax obligations. The European Commission suggests that Member States allow loss carry-back for businesses to at least the previous fiscal year to allow businesses which were profitable in the years before the pandemic to offset their 2020 and 2021 losses against the taxes they paid before 2020.

Why this non-binding suggestion requires pan-European action is not immediately clear, as to our knowledge, Member States are well aware of this possibility and some have indeed already implemented such measures in their laws previously.

Debt Equity Bias Reduction Allowance (DEBRA)

The European Commission observes that since the current tax framework incentivises companies to finance investments through debt rather than through equity (since companies can deduct interest attached to debt financing but not the costs related to equity financing), there is a persisting pro-debt bias of tax rules.

Since this issue has become more pressing in the current context of the COVID-19 crisis where the stock of debts of companies has increased significantly, by the beginning of 2022, the Commission will make a proposal to introduce an allowance system for equity financing, thus contributing to the re-equitisation of financially vulnerable companies. The proposal will incorporate anti-abuse measures to ensure it is not used for unintended purposes. This may turn out to be a variation of a "notional interest deduction" on equity that was previously suggested in the context of the CCCTB proposals and has been implemented already in some Member States with varying degrees of success.

Implementation of the global corporate tax reform at EU level & impact on existing rules

As far as the reform of the international corporate tax framework (Pillars 1 & 2) is concerned, once agreed and translated into a multilateral convention, the application of Pillar 1 will be mandatory for participating countries.

- In order to ensure its consistent implementation in all EU Member States, including those that are not Members of the OECD and do not participate in the Inclusive Framework, the Commission will propose a Directive for the implementation of Pillar 1 in the EU.

- In order to ensure its consistent application within the EU and compatibility with EU law, the principal method for implementing Pillar 2 will be an EU Directive which will reflect the OECD Model Rules with the necessary adjustments.

The implementation of a global agreement on minimum effective taxation will also have implications for existing and pending EU Directives and initiatives:

- Implementation of an international agreement on minimum effective taxation (Pillar 2) will have implications for existing rules under the ATAD, specifically for the Controlled Foreign Company (CFC) rules, which will interact with the primary rule under Pillar 2 (the Income Inclusion Rule or 'IIR'). When the IIR is implemented in the EU, the Commission considers that it will be necessary to explore how to best accommodate the interaction between the two rules.

- In addition, according to the Commission, the implementation of Pillar 2 into EU law should pave the way for agreeing the pending proposal for recasting the Interest and Royalties Directive ("**IRD**"), which has been in the Council since 2011. The aim of the recast Directive was to make the benefits of the Directive (which eliminates withholding tax obstacles to cross-border interest and royalty payments within a group of companies) conditional on the interest being subject to tax in the destination state. Some Member States held the view that the IRD should go further and set a minimum level of tax in the destination state as a condition for benefiting from the absence of withholding tax. Agreement on Pillar 2 will resolve this issue.

Finally, as reflected in the recent Communication on Tax Good Governance in the EU and Beyond, the Commission will propose to introduce Pillar 2 in the criteria used for assessing third countries in the EU listing process, so as to incentivise them to join the international agreement. This is in line with the EU's existing approach to use the listing process to promote internationally agreed good practices.

The way forward

The European Commission has announced very extensive and ambitious tax reforms which would come on the top of the tax reforms which will take place in the coming months, when implementing the international standards of Pillar 1 and Pillar 2 to be agreed upon at OECD level. Even if it will be necessary to await the release of the various Commission's proposals in order to understand their exact scope of application and how they will work, it is already clear now that many of them, especially BEFIT, will have to face some significant challenges and discussions among the EU Member States. There may be a question of political priorities, as the actions proposed in business taxation are firstly, targeting a relatively small part (7%) of the overall tax receipts of the Member States and secondly, will be coming after an extensive series of measures that already significantly prevent tax avoidance (EU ATAD 1&2, OECD Pillar 1 and 2) and provide for extensive transparency (DAC 1-7). Nonetheless, we will be watching the space with interest and will update you as matters progress.

Do you have further questions?

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