

European Commission proposes staged approach towards harmonized group tax base

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Mandatory Common Corporate Tax Base is the first step with Common Consolidated Corporate Tax Base as final step

Executive summary

On 25 October 2016, the European Commission (the Commission) announced a new package for corporate tax reforms.

The package includes three separate legislative initiatives, namely: (i) a Directive on a Common Consolidated Corporate Tax Base (CCCTB); (ii) a Directive on Double Taxation Dispute Resolution Mechanisms in the European Union; and (iii) a Directive amending the Anti-Tax Avoidance Directive (ATAD) as regards hybrid mismatches with third countries. These legislative proposals will be submitted to the European Parliament for consultation and to the Council of the European Union for adoption.

The Package also contains a Chapeau Communication, outlining the political and economic rationale behind the proposals, as well as impact assessments on the CCCTB and the dispute resolution mechanism.

With respect to the CCCTB proposal, the Commission recognizes that elements of the original CCCTB proposals gave rise to difficult debates and consequently has proposed a staged approach. Accordingly, the proposal has been split into two directives, one covering a common corporate tax base (CCTB) and the other covering the CCCTB itself. Discussions on the draft directive relating to the CCCTB will be postponed until the elements of the CCTB are agreed.

The first stage in the re-launched proposals contains a set of rules to create a CCTB but does not include consolidation rules. These are broadly the same as the relevant aspects of the 2011 proposals, though they have been updated to take into account the European Union's (EU's) work on the ATAD.¹ The proposals now also incorporate a notional interest deduction and a super-deduction for research and development (R&D).

Detailed discussion

Background

The re-launch of the CCCTB Directive forms part of the Commission's *2015 Action Plan for a Fair and Efficient Corporate Tax System in the European Union*. The CCCTB is considered to be a holistic approach to profit shifting by ensuring effective taxation where profits are generated.

Recognizing the previous difficulties in reaching agreement on a CCCTB, the Commission has decided to follow a two stage process. The first stage seeks agreement for a CCTB with the second stage including the more contentious consolidation aspects, which will only be taken forward after political agreement has been reached on the CCTB proposal.

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Scope of the rules

The proposal is for the rules to be mandatory for groups with consolidated worldwide revenues greater than €750m in the preceding year, whereas under the previous proposals, the rules were to be optional. The scope covers EU tax resident companies as well as EU permanent establishments of non-EU companies.

The CCTB will be optional for other companies, which can elect into the regime for a period of five years (automatically renewed until a notice of termination is given). Companies that

do not opt in would remain subject to the (existing) national laws of the territory in which they are resident. The rules will not apply to shipping companies under a special tax regime.

Taxable income and deductible expenses

The proposal sets out a number of rules for calculating the tax base under the CCTB. Broadly, all revenues (which include proceeds of sales, proceeds from the disposal of assets and other profit distributions) will be taxable, although the CCTB rules include the following:

- ▶ A **participation exemption for chargeable gains** on the disposal of shares where the taxpayer has held at least 10% of the capital or voting rights for 12 months leading up to the disposal - this would apply to both trading and investment companies.
- ▶ An **exemption for distributions** received, although a minimum holding of 10% of the capital or voting rights is required which must be held for 12 consecutive months. Life insurance undertakings and companies holding shares for trading are not able to benefit from the exemption.
- ▶ A **foreign permanent establishment exemption** which applies automatically rather than giving companies a choice.
- ▶ An **allowance for equity** combined with **restrictions on relief for interest** (see below).
- ▶ Proscribed **tax relief for depreciation** and **enhanced relief for R&D expenditure** (see below).
- ▶ A list of **non-deductible expenditures** such as fines and penalties, bribes, distributions, entertainment and capital costs.
- ▶ **Mandatory exit taxation** based upon market value at the time of exit less value for tax purposes, on the transfer of assets, operations or residence.
- ▶ A **permanent establishment (PE)** definition closely aligned with the recommendations from the Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project, covering only PEs situated within the EU and belonging to a taxpayer who is resident within the EU. The third-country dimension is thus left to be dealt with in bilateral tax treaties and national law.
- ▶ The rules also deal with provisions, bad debts, hedging arrangements and contain transitional rules where companies enter and leave the CCTB regime.
- ▶ Transactions between a taxpayer and its associated enterprise(s) should be subject to pricing adjustments in line with the **arm's length principle**.

Fixed assets

Businesses will be able to claim depreciation on fixed assets (including intangible fixed assets) as a deductible expense based upon prescribed rules.

Individually depreciable assets, which include commercial buildings, industrial buildings, long life assets, and medium life assets (a new category from the 2011 proposals), are depreciated on a straight line basis over their defined useful life.

Intangible assets and the R&D super deduction

Intangibles fixed assets, including Intellectual Property will be depreciated over the period for which the asset enjoys legal protection or for which the right has been granted. Where this cannot be determined, a default period of 15 years applies.

The CCTB does not contain any provisions to allow for a beneficial IP regime, such as a Patent Box which is seen in a number of EU Member States. However, the proposals do include an enhanced deduction for expenditure on R&D.

R&D costs will be fully expensed in the year incurred. Businesses may claim an additional 50% deduction for R&D expenditure up to €20m and an additional 25% on costs over that. Small, stand-alone entities that are less than five years old can potentially claim a 100% extra deduction on R&D expenditure up to €20m.

Allowance for Growth and Investment and financing costs

To remove the bias towards debt, the Commission proposes a notional interest deduction on equity. This Allowance for Growth and Investment will allow businesses to deduct a notional yield on equity increases after the CCTB rules enter into force. Equity reductions eliminating the amounts on which the allowance is given will in turn give rise to taxable amounts.

The notional yield will be calculated based upon the Euro area 10 year government benchmark bond yield in December of the year preceding the relevant tax year, increased by a risk premium of 2 percentage points (a floor of 2% will apply where the benchmark bond yields are negative).

The proposals also include an interest expense limitation for groups, based on - but not exactly similar to - the interest imputation included in the ATAD. This will see deductible interest expenses limited to the higher of 30% of the EBITDA² (calculated by adding back tax-adjusted borrowing costs, depreciation and amortization to the tax base) or €3m, which is in line with the recommendation in the OECD BEPS

project, although the CCTB does not include a Group Ratio Rule. Interest expenses not deductible are carried forward. The limitation does not apply to loans concluded before the (future) date of political agreement of the CCTB Directive or to long term public infrastructure funding.

Anti-avoidance measures

The proposals incorporate the measures included in the ATAD which implement certain aspects of the OECD's BEPS proposals in the EU, including those announced to amend the ATAD alongside the CCTB proposal. The key measures are:

- ▶ **General Anti-Abuse Rule** - this rule disregards non-genuine arrangements put in place with the essential purpose of obtaining a tax advantage.
- ▶ **Anti-hybrid mismatch rules** - these rules target both intra-EU hybrid mismatches as well as mismatches with third countries including provisions dealing with imported mismatches, PEs and tax residency mismatches.
- ▶ **Controlled foreign company (CFC) rules** - these apply to an entity, or a PE whose profits are not subject to tax or are exempt from tax in the head office's territory, where the actual tax paid is less than half of the tax that would have been paid in the Member State of the taxpayer. In the case of entities, the rules apply where the taxpayer holds a direct or indirect participation of more than 50%.
- ▶ **Switch-over rule** - despite the removal of such a rule from the ATAD in order to secure agreement, a "switch-over" clause has been included in the CCTB. This requires a change from an exemption regime to a credit regime for gains on the sale of shares of, or distributions from, a company in a third country where the statutory tax rate is less than half the statutory rate the taxpayer would have been subject to. The rule will not apply where a bilateral treaty prevents switching from an exemption to a credit method.

Losses

The rules allow for an indefinite carry-forward of tax losses, although no carry-back of losses is available. However, there is no restriction on the utilization of losses as seen in a number of EU Member States. The proposals do however include provisions to prevent losses being used where there has been a change in ownership and a major change in activity.

To compensate taxpayers until the consolidation aspects contained in the postponed CCCTB Directive are adopted (which effectively allows automatic cross-border loss relief), the CCTB proposal provides for a limited current year sharing of losses within the EU. However, the losses will only be available to the direct parent (or head office of a PE) and

will be recaptured as the subsidiary or PE starts to make profits. After five years, all remaining losses claimed will be recaptured. The current draft does not appear to allow for greater loss offset between entities within a territory although this might be amended if the proposals get adopted.

Timing

The proposed draft directive for the CCTB suggests that the Member States should adopt and publish, by 31 December 2018 at the latest, laws to implement the CCTB, with the rules being in force from 1 January 2019. This is the same timescale in which the ATAD, agreed in June 2016, is required to be implemented. However, it is noted that certain measures of the ATAD (e.g., exit taxation and interest deduction) have a later effective date.

CCCTB Directive proposals

The second draft directive, containing the CCCTB proposal, suggests that the regime should be in force by 1 January 2021. However, although the CCTB and CCCTB were published concurrently, the CCCTB discussions will not progress until agreement has first been reached on the CCTB.

The CCCTB proposal is for the tax base, calculated by adding together the tax bases of the constituent members of the group and eliminating intra-group transactions (eliminating the need for intra-EU transfer pricing rules), to be apportioned among Member States using a formulaic approach, taking into account, with equal weighting, the proportion of sales, employees (looking at both payroll costs and numbers of employees) and assets sitting in each Member State (intangibles and financial assets will be excluded).

It provides that the Member State in which the parent of the consolidated group is resident will undertake the administration aspects, including tax audits (which may be raised at the request of a competent authority in another Member State) covering all the relevant group members. These are effectively all members of the group that are tax resident within the EU or have a PE there. The consolidated tax return and supported documentation filed by the principal taxpayer will be stored in a central database to which competent authorities in all Member States will have access.

Next Steps

Recognizing the previous difficulties in reaching agreement on a CCCTB, the Commission has decided to follow a two stage process. As noted, the first stage seeks agreement for a CCTB with the second stage including the more contentious consolidation aspects, which will only be taken forward after political agreement has been reached on the CCTB.

The adoption of the CCTB (and the CCCTB) requires unanimity of the Member States. The presentation as an anti-avoidance measure may put pressure on Member States to accept the general principle of the CCTB and debate the detail, as was seen in the recent process of the ATAD.

These legislative proposals will be submitted to the European Parliament for consultation and to the Council for adoption. All Member States will have to sign up to this proposal before it can be adopted, and each Member State would then need to incorporate it into their national law. In that respect, the draft CCTB Directive proposes that Member States shall adopt and publish the CCTB Directive by 31 December 2018 at the latest, and shall apply its provisions from 1 January 2019. The second draft directive, containing the CCCTB proposals, suggests that the regime should be in force by 1 January 2021. However, the CCCTB discussions will not progress until agreement has first been reached on the CCTB.

Implications

According to the Commission, the C(C)CTB proposals are perhaps the most ambitious corporate tax reform ever proposed in the EU. Both would provide Member States with an entirely new system for taxing multinationals and it will have a significant effect on the taxation of multinational companies operating in the EU. If adopted, a broad range of structures (financing, holding, IP and supply chain structures) will be impacted. Global businesses with European activities may therefore wish to assess the impact of the proposals on their current structures and on future investments, and should monitor the follow up work by the Commission and the Council.

Endnotes

1. See EY Global Tax Alert, *ECOFIN reaches political agreement on Anti-Tax Avoidance Directive*, dated 21 June 2016.
2. Earnings before interest, taxes, depreciation and amortization.

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