PROPOSED DIRECTIVE ON THE E.U. COMMON (CONSOLIDATED) CORPORATE TAX BASE – A PRIMER

Author
Stefano Grilli

Tags
C.C.T.B.
C.C.C.T.B.
European Commission
MNE Planning
Permanent Establishment
Tax Administration

Stefano Grilli is a Partner at Gianni, Origoni, Grippo, Cappelli & Partners, Milan. His practice focuses on the tax aspects of debt capital markets and equity capital markets transactions. Mr. Grilli holds a degree in Economics from the University "Luigi Bocconi" of Milan, an Adv. LL.M in International Taxation from Leiden University, Netherlands, and a Ph.D. from the University of Bergamo.

INTRODUCTION

On October 25, 2016, the European Commission announced major corporate tax reforms for the E.U. market. In particular, the European Commission issued three proposal directives that deal with (i) the Common Corporate Tax Base ("C.C.T.B.") and the Common Consolidated Corporate Tax Base ("C.C.C.T.B."), (ii) resolution of double tax disputes, and (iii) mismatches with non-E.U. Countries.

Regarding the C.C.C.T.B. and C.C.T.B. proposals (collectively, the "Proposal Directive"), the European Commission essentially revamped a failed 2011 proposal in light of recent developments in the international tax environment (*e.g.*, the O.E.C.D. B.E.P.S. Project and the Action Plan for a Fair and Efficient Corporate Tax System in the E.U.). It may be "old wine," but the new bottles may make it drinkable.

As Commissioner for Economic and Financial Affairs, Taxation and Customs Pierre Moscovici stated:

> With the rebooted CCCTB proposal, we're addressing the concerns of both businesses and citizens in one fell swoop. The many conversations I've had as Taxation Commissioner have made it crystal-clear to me that companies need simpler tax rules within the EU. At the same time, we need to drive forward our fight against tax avoidance, which is delivering real change. Finance Ministers should look at this ambitious and timely package with a fresh pair of eyes because it will create a robust tax system fit for the 21st century.[1]

The project appears to be extremely ambitious, as the Proposal Directive would have a huge impact on the tax systems of the E.U. Member States. Indeed, should the Proposal Directive be approved, Member States would lose autonomy to set rules concerning the corporate tax bases of companies falling within the ambit of the Proposal Directive – companies that carry-on business within the E.U. market and belong to a multinational group with a total annual turnover in excess of €750 million. The Proposal Directive intrudes on the sovereignty of E.U. Member States in regard to internal income tax systems, leaving them little leeway with respect to corporation tax matters other than the establishment of a corporate tax rate in accordance with national budgetary policy. The computation of income, the allowance of credits, and accelerated deductions would be set centrally by the European Commission.

To overcome the difficulties preventing the approval of the 2011 proposal, the European Commission has overhauled the proposal – advocating for a new two-step approach. Even though the C.C.C.T.B. and C.C.T.B. proposals have been

[1] European Commission, "Commission Proposes Major Corporate Tax Reform for the EU," news release, October 25, 2016.

submitted simultaneously by the European Commission, they represent two distinct phases that contemplate an initial approval of the C.C.T.B. and subsequent approval of the C.C.C.T.B.

AIM OF THE PROPOSAL DIRECTIVE

The Proposal Directive aims at providing E.U.-resident companies and foreign companies doing business across the internal market with a single set of corporate tax rules for calculating the tax base, thereby allowing these companies to treat the E.U. as a single market for corporate income tax purposes as well as V.A.T. purposes. The intention is to create a fair and level playing field no matter where a corporation is resident, to provide certainty to taxpayers, and to reduce costs, administration burdens, and red tape.

The Proposal Directive is expected to constitute an effective tool against tax avoidance, as the application of a single set of rules across the E.U. market would eliminate mismatches between national systems that may be exploited by aggressive tax planners, resulting in base erosion and profit shifting. Moreover, tax avoidance risk would be reduced because a uniform base would be expected to eliminate the incentive to manage transfer prices of goods, services, and the use of intangible property with the goal of directing profits towards group members based in countries with preferential tax regimes.

With regard to transfer pricing, the Proposal Directive endorses an arm's length principle that reflects the O.E.C.D. standard. In this respect, it should be noted that under the C.C.C.T.B. proposal transfer pricing only applies to intra-group dealings involving E.U.-resident companies and third-country-resident companies. In comparison, intra-C.C.C.T.B. group dealings fall outside the scope of arm's length transfer pricing because consolidated income would be subject to formulary apportionment.

The Proposal Directive also includes specific rules to address key actions under the B.E.P.S. Project. In particular, the Proposal Directive provides for (i) a general anti-abuse rule ("G.A.A.R."), (ii) a controlled foreign corporation ("C.F.C.") rule, (iii) a switch-over clause, and (iv) an anti-hybrid mismatch rule.

OUTLINE OF THE PROPOSAL DIRECTIVE

Subjective Scope

The Proposal Directive applies to companies, including permanent establishments ("P.E.'s"), based in a Member State that belong to a consolidated group with a total consolidated group revenue exceeding €750,000,000 during the prior financial year. Companies established under the laws of a third country also fall within the scope of the Proposal Directive with respect to each P.E. situated in a Member State. The Proposal Directive provides specific requirements regarding company form, liability to specific taxes, and the controlling relationship between a parent company and its subsidiaries. The application of the rules set forth by the Proposal Directive is mandatory for all entities and P.E.'s so described.

Companies that do not belong to a consolidated group with total consolidated group revenue exceeding €750,000,000 during the prior financial year but meet all the other conditions provided for by the Proposal Directive may elect to apply the C.C.T.B.

and C.C.C.T.B. rules. The election would remain in effect for a period of at least five tax years. This election includes affiliates and P.E.'s situated in other Member States.

P.E. Definition

The Proposal Directive provides for a definition of a P.E. that reflects the standard laid down in Article 5 of the O.E.C.D. Model Tax Convention, including the proposed amendments suggested by B.E.P.S. Action 7 – Preventing the Artificial Avoidance of Permanent Establishment Status.

The definition applies to a P.E. of an E.U.-resident taxpayer, if that P.E. is established in a Member State. However, if a P.E. of an E.U.-resident taxpayer is established in a third country or a P.E. of a third-country-resident taxpayer is established in a Member State, the P.E. will continue to be governed by the provisions of the tax treaty concluded between the third country and the E.U. Member State, and the domestic tax laws of the states involved.

"Eligibility for the C.C.T.B. and the C.C.C.T.B. will be determined in accordance with a two-part test based on control and ownership or profit rights."

Definition of Group

Eligibility for the C.C.T.B. and the C.C.C.T.B. will be determined in accordance with a two-part test based on control and ownership or profit rights. Control means the right to exercise more than 50% of the voting rights of another corporation. Ownership or profit rights means ownership of more than 75% of the subsidiary's capital or rights to more than 75% of the subsidiary's profits.

In calculating the thresholds for control and ownership or profit rights in relation to lower-tier subsidiaries, the following rules apply:

- Once the voting-right threshold is reached in respect of a subsidiary, the parent company will be considered to hold 100% of these rights.
- Entitlement to profit and ownership of capital will be calculated by multiplying the interests held, directly or indirectly, in subsidiaries at each tier. Ownership rights amounting to 75% or less held, directly or indirectly, by the parent company will be taken into account in the calculation. Indirect ownership rights will be taken into account whether the intermediary company is based in a Member State or outside the E.U.
- A taxpayer who is a group member must meet the above-mentioned thresholds without interruption, throughout the tax year. Newly acquired companies and companies that have been sold to third parties will be treated as group members if held within the group for a minimum period of nine consecutive months. If that minimum period of ownership is not met, the company will be treated as a non-member for the entire year. A taxpayer ceases to be a group member the day after it no longer meets the thresholds for control and ownership or profit rights.

Features of the C.C.T.B. and C.C.C.T.B.

The Proposal Directive contains the following features:

- A system is adopted for the establishment of a common base for the taxation of companies that are members of a group.

- Rules regarding the calculation of the base are established under the C.C.T.B. proposal.
- Rules regarding the allocation of the consolidated tax base to Member States and administration by the national tax authorities are established under the C.C.C.T.B. proposal.
- The tax base is to be calculated as revenues less exempt revenue, deductible expenses, and other deductible items.

Exempt Revenue

Exempt revenue includes, *inter alia*, capital gains from disposals of shares and dividend distributions, although specific exclusions apply to eliminate double taxation at the corporate level within certain related corporations.

Regarding capital gains, a participation exemption generally applies to proceeds from a disposal of shares, provided that the taxpayer has maintained a minimum holding of 10% in the capital or voting rights of the company during the 12 months preceding the disposal.

Regarding profit distributions, a participation exemption applies to the receipt of profit distributions, provided that the taxpayer has maintained a minimum holding of 10% in the capital or voting rights of the distributing company for 12 consecutive months. When a corporation establishes a P.E. in another Member State, profits distributed to the corporation's head office will qualify as exempt revenue.

Deductible Expenses

Expenses are deductible only to the extent that they are incurred in the direct business interest of the taxpayer.

"Super-Deduction" of Research and Development Expenses

Regarding research and development ("R&D") expenses, a "super-deduction" is granted to the taxpayers in addition to the R&D costs incurred for the purposes of the business. The super-deduction amounts to an extra 50% of the costs incurred during that year. When computing the super-deduction cost base, costs related to movable tangible fixed assets are excluded. Presumably, this means that expenditures for machinery and equipment are not eligible for the super-deduction.

To the extent that R&D costs exceed €20,000,000, the taxpayer may deduct 25% of the excess. The deduction ceiling may be further increased for start-up companies that meet specific conditions.

Allowance for Growth and Investment

The Proposal Directive also provides for an Allowance for Growth and Investment ("A.G.I."), which is intended to put equity and debt financing on similar a footing and boost growth. Under the measure, taxpayers are granted a tax-deductible notional yield computed on equity increases. The notional yield corresponds to the Euro Area 10-Year Government Benchmark Bond Yield as of December of the preceding tax year, as published by the European Central Bank, increased by a 2% risk premium. A 2% floor applies where the curve of the annual yield is negative. Equity base decreases are taxable in the hands of the taxpayer to an amount that corresponds

to the notional yield computed on the relevant equity base decrease. Companies incurring losses will find that the loss is magnified to the extent of the clawback of prior benefits of the notional yield under the A.G.I.

Interest Limitation Rule

The Proposal Directive provides for an interest limitation rule based on a fixed ratio of net interest to earnings before interest, tax, depreciation, and amortization ("E.B.I.T.D.A.") that resembles the limitation established in Article 4 of the E.U. Anti-Tax-Avoidance Directive (the "A.T.A. Directive"). According to the rule, borrowing costs are deductible to the extent of interest, or other taxable revenues from financial assets, received by the taxpayer. Excess borrowing costs are deductible in the tax year in which they are incurred up to 30% of the taxpayer's E.B.I.T.D.A. (fixed ratio rule) or €3,000,000, whichever is greater. The interest limitation rule also provides for a group ratio rule, a carryforward rule, and a grandfathering clause.

Losses

Losses incurred in a tax year by a resident taxpayer or a P.E. of a nonresident taxpayer may be carried forward indefinitely and deducted in subsequent tax years. The Proposal Directive also provides for a specific anti-abuse provision that tackles abusive planning intended to circumvent the rules on loss deductibility through the purchasing of loss-making companies.

G.A.A.R.

The Proposal Directive provides for a G.A.A.R. in line with the rule adopted in the A.T.A. Directive. The G.A.A.R. is designed to cover gaps that may exist in Member State' specific anti-abuse rules. Taking into account all relevant facts and circumstances, Member States are entitled to disregard an arrangement, or a series of arrangements, that has been put in place for the essential purpose of obtaining a tax advantage that defeats the object or purpose of the Proposal Directive and is therefore not genuine. An arrangement is to be regarded as non-genuine to the extent that it is not put in place for valid commercial reasons that reflect economic reality. If an arrangement falls within the scope of the G.A.A.R., a substance over form approach will apply. When calculating the tax base, the arrangement will be treated by reference to its economic substance.

Formulary Apportionment

Under C.C.C.T.B., the consolidated tax base is apportioned among the group members in each tax year on the basis of a formula. The formula takes into consideration three equally weighted factors, *viz.*, labor, assets, and sales by destination. In this way, the C.C.C.T.B. is intended to reflect a balanced approach to distributing taxable profits amongst eligible Member States. The labor factor is weighted equally between payroll and headcount of employees in order to account for wage gaps across the E.U. The asset factor consists of all fixed tangible assets. Intangibles and financial assets are excluded from the formula due to their mobile nature and the risks of circumventing the system. Profits and losses arising from intra-group transactions are eliminated when calculating the consolidated tax base.

A safeguard clause is provided for by the C.C.C.T.B. proposal in cases where the parent company of the group (the "Principal Taxpayer") or a competent authority considers that the outcome of the apportionment of the consolidated tax base to a

group member does not fairly represent the extent of the business activity of that group member. In such a case, the safeguard clause allows the Principal Taxpayer or competent authority to request the use of an alternative method for calculating the tax share of each group member. Specific rules apply to particular sectors, such as financial services and insurance, oil, and gas as well as shipping and air transport.

Administrative Procedures

The Directive Proposal will have a significant impact on the administrative procedures. Indeed, while companies applying only the C.C.T.B. rules will continue to fall within their national administrative provisions, taxpayers involved in the C.C.C.T.B. will deal with a single tax administration ("Principal Tax Authority") in the E.U. The Principal Tax Authority is the one based in the Member State where the Principal Taxpayer resides for tax purposes. The Principal Tax Authority is empowered to initiate and coordinate tax audits involving the consolidated group.

However, the national authorities of any Member State in which the profits of a group member are subject to tax may request the initiation of an audit. Moreover, the competent authority of a Member State in which a group member is tax resident, or a P.E. is established, may challenge a decision by the Principle Tax Authority concerning a notice to create a group or an amended tax assessment. This challenge must be made before the courts of the Member State of the Principal Tax Authority.

Disputes between taxpayers and tax authorities will be dealt with by an administrative body that will be competent to hear appeals at first instance according to the laws of the Member State of the Principal Tax Authority.

CONCLUSION

The Proposal Directive, if approved, will have a massive impact on Member States' tax systems. Indeed, the enactment of the E.U. single market through the Proposal Directive will result in a significant limitation of Member State autonomy on a crucial tax matter. That is why, at this stage, it appears difficult to predict whether a unanimous favorable decision will be reached. Moreover, even if the Proposal Directive is approved, the entry into force of the relevant provisions will not take place until 2019 with regard to the C.C.T.B. and 2021 with regard to the C.C.C.T.B.

Given the existing uncertainty regarding the approval of the Proposal Directive and the time span between approval and actual implementation of the relevant provisions, it appears too early for multinational companies that fall within the scope of the Proposal Directive to begin revising E.U. structures to cope with the provisions. It is, however, crucial for multinational companies and practitioners to keep updated on the development of the project and to the possible outcome of the Proposal Directive.

Disclaimer: *This article has been prepared for informational purposes only and is not intended to constitute advertising or solicitation and should not be relied upon, used, or taken as legal advice. Reading these materials does not create an attorney-client relationship.*