The **BEPS** Monitoring Group

SUBMISSION TO THE EUROPEAN COMMISSION CONSULTATION

on the

COMMON CONSOLIDATED CORPORATE TAX BASE

Questions 1-3 ask for check-box answers about the respondent.

4. Policy Directions

The Commission believes that the CCCTB system can be an effective tool against aggressive tax planning and at the same time retain its attractiveness to the business.

What are your views?

- I agree X
- Neutral
- I don't agree
- Other

Comments:

If appropriately designed, the CCCTB is the only effective way to ensure fairness in corporate taxation within a single market. This is clear from integrated markets in federal states such as the USA, Canada and Switzerland. Retaining state corporate tax powers in a single market with an unrestricted right of establishment for companies inevitably leads to tax competition, which damages all states, and undermines corporate taxation. Experience in the EU shows that other methods of attempting to curb such tax competition are ineffective, and that if unchecked it can have extremely damaging effects on public confidence in the fairness of taxation.

The CCCTB should also be attractive to business, because it could provide equity between purely national companies and those engaged in cross-border investment, especially from outside the EU. It would also level the playing field between firms which adopt responsible tax policies, and those willing to engage in aggressive tax planning. The vast majority of SMEs are not able to take advantage of the possibilities of international tax planning, yet their views may not be given enough weight, as the larger cross-border firms have much greater resources in responding to consultations, as well as finding other methods to influence policy.

However, it is crucial to ensure that the CCCTB is properly designed, not only as regards its intra-EU effects, but perhaps even more importantly its effects on international base erosion and profit shifting (BEPS). The CCCTB must include suitable rules to ensure that the common EU tax base it defines is appropriate in relation to the extra-EU activities of the firms concerned. A poorly designed CCCTB could permit or even encourage profit shifting out of the EU. As importantly, the CCCTB should be designed to ensure that EU-based firms do not shift profits out of non-EU source countries, especially poor developing countries, while keeping such profits 'offshore', in non-EU tax havens.

The Commission envisages re-launching the CCCTB in a staged approach which will consist of 2 steps: Firstly, agreement on the tax base, secondly, moving on to consolidation. What are your views on the staged approach?

- I'm in favour of the staged approach
- Neutral
- <u>I'm against the staged approach X</u>
- Other

The proposed staged approach makes no sense in policy terms, and the reasons given for considering it do not seem apposite. The only reason to adopt a CCTB would be as a step towards the full CCCTB, without that it would not be justified. The political difficulties need to be resolved in any case, and attempting to do so in two stages does not make it easier. There is already considerable political support now for measures to resolve the problem of corporate tax avoidance, and the issue continues to be very high among the concerns of citizens in many member states. A 2-step approach would simply provide opponents with reasons to defer the essential step towards consolidation and apportionment. One way or another, the nettle should be grasped.

It is a priority of the Commission to promote discussion in Council of certain BEPS-related international aspects of the common base before the re-launched CCCTB is proposed. The aim will be to arrive at consensus on how to implement certain OECD anti-BEPS best practice recommendations in a uniform fashion across the EU. The intention would be to create a common playing field in defending the Single Market against base erosion and profit shifting.

What are your views on agreeing on such a common approach?

- I'm in favour of such a common approach
- I'm against such a common approach
- Don't know
- Neutral
- <u>Other X</u>

Common anti-BEPS measures should include not only the the BEPS project's minimum standards but also effective measures on its recommendations, especially interest deductions and CFCs. This could increase support for adoption of the CCCTB, while a weak common position would enable continued tax competition as well as BEPS behaviour, both within the EU and outside. Adopting the lowest common denominator of each national position would

be pointless and indeed damaging, by locking the EU in to rules which would be ineffective but harder to change.

Effective CFC rules are crucial. They should be on a full-inclusion basis, treating all foreign affiliates of EU-resident parent companies as CFCs so that the group consolidated profits are subject to tax in the resident country, with a full credit for all equivalent foreign taxes paid, which under the CCCTB should be apportioned among the group's EU affiliates by an appropriate formula. This would protect the tax base of both source and residence countries. They should certainly not be limited to income from transactions with the parent company, and there should be no exemptions based on criteria such as effective exchange of information, as profits may also be shifted into cooperative jurisdictions. Full-inclusion CFC rules would be easier to apply than attempting to distinguish between active and passive income, or using a threshold such as 40% of the taxpayer's effective tax rate. This is hard to calculate; it sets an arbitrary limit, and there is no particular rationale to any limit that could be chosen. It would encourage continued BEPS behaviour, as companies would still have an incentive to shift profits out of high-tax source countries into countries offering an effective tax rate just above the CFC limit; and would create a downward ratchet as tax competition leads states to reduce their tax rates, in turn reducing the CFC tax rate limit.

5.1 Scope, Anti-Avoidance

The Commission considers making the new proposal for a CCCTB obligatory for all EU companies which are part of a group. A group can be formed:

- Between parent and subsidiary companies where there is a holding of more than 50% of the voting rights; and direct or indirect holding amounting to more than 75% of capital or more than 75% of the profit rights); or

- Between a Head Office and its permanent establishment where a company has one or more permanent establishment in other Member States.

What are your views on making the proposal for a CCCTB obligatory for all EU companies which are part of a group?

- <u>I'm in favour of this obligation X</u>
- I'm against this obligation
- Neutral
- Don't know
- Other

It would indeed make sense for all entities which are part of a group to be treated on a consolidated basis. This should include not only those with their ultimate parent resident in the EU, but also all affiliates of a non-resident parent with a taxable presence in the EU. We are also in favour of compulsory application of the full CCCTB to all cross-border corporate groups, i.e. those with an affiliate or a PE in more than one member state. However, it seems to us that it would be hard to justify compulsory application of a CCCTB to all EU companies even if they have no cross-border activities. This would seem not to comply with

the requirements of proportionality and subsidiarity, and it does not seem that compulsion would be justified by the need to ensure non-discrimination.

The Commission envisages providing the following option:

Companies which would not be subject to the mandatory CCCTB - because they do not fulfil the requirements of being part of a group - could still have the possibility to apply the rules of the system. What are your views on offering non-qualifying companies the option to apply the rules?

- I'm in favour of this option
- Neutral
- I'm against this option X
- Don't know
- Other

We are not clear what the intention would be for providing this option. The aim of the CCCTB should be to establish a system for a fair apportionment of the tax base for companies with a taxable presence in more than one EU member state. It should be a matter for each member state to decide whether it wishes to use the same tax base definitions as in the CCCTB for its resident companies which do not have cross-border operations, in which case it would apply to all companies. It is not clear why, or on what basis under EU law, companies with no cross-border operations could be offered the choice of using the CCCTB tax base definitions rather than those otherwise applicable under the law of their state of residence. Allowing member states the option of using the common tax base definitions for all corporate tax purposes might be more defensible and appropriate, however.

5.2 Anti-avoidance elements

In view of recent developments, the CCCTB system should include more robust rules to defend itself against aggressive tax planning. Which of the elements of the CCCTB system would you reinforce so that the system can better respond to tax avoidance?

(Multiple answers possible)

- Rules for limiting interest deductibility X
- Disallowance of tax exemption for portfolio participations X
- Exit taxation rules X
- More robust rules on controlled foreign companies regimes (CFC)X
- Anti-abuse rules based on effective rather than statutory rates X
- Addressing distortions caused by debt/equity bias X
- Other suggestion X
- None of the above

Comment

The CCCTB needs to include measures to (i) protect the corporate tax base within the European Union, (ii) ensure that corporate profits are not artificially shifted into Europe via cross-border payments from other jurisdictions, particularly developing countries, and (iii) ensure that profits are not shifted out of the EU especially to offshore jurisdictions. As outlined in our other comments, effective CFC rules based on full inclusion are the key to this, and the EU is in a position to take a lead which could ensure an effective global system of corporate taxation.

The intra-group interest deduction limitation should be set at 10% of EBITDA, the lowest level recommended by the BEPS project report, with the option of a group-wide limitation, since debt-equity ratios vary widely both between economic sectors and even between firms in the same sector. A higher cap would allow some companies to use internal lending in excess of their 3rd party borrowing for BEPS purposes. The OECD's 2014 report on Action 4 showed that of the largest non-financial companies, 69 out of 77 had a net interest to EBITDA ratio below 10% in 2009, and in 2013 75 out of 79. The fuller study by PwC for BIAC of a wider range of companies showed a higher proportion with higher ratios: 39-45% of MNEs had interest expense over 10% -- but this means that over half were below 10%. Only 17-22% had a ratio over 30%, so this would clearly be too high. The evidence from Germany's 30% cap is that companies have rarely opted for the group ratio, which shows that 30% is far too high. Problems such as volatility of earnings, and project life-cycles can be dealt with by flexible rules on carry-forward and carry-back. The definition of interest can be dealt with by enacting a broad principle covering all payments economically equivalent to interest, together with more detailed and specific regulations and illustrative examples.

6. Hybrid Mismatches, Research and Development

6.1 Hybrid mismatches are the result of disparities in the tax treatment of an entity or financial instrument under the laws of two or more States. Currently, arrangements can be set up to exploit such mismatches for the purpose of lowering their overall tax burden. The risk of such arrangements would be removed in transactions between enterprises applying the common tax base rules within a consolidated group. It would however persist in relations with enterprises outside the common rules as well as during step 1 of the staged approach to a CCCTB, in the absence of tax consolidation amongst the companies applying the common rules. One option to address hybrid mismatches would be to require enterprises to follow in a Member State the classification of entities and/or of financial instruments adopted in the other Member State or the third country which is party to the transaction.

In your view, can hybrid mismatches be effectively addressed through any other measures than the one suggested above?

- Yes X
- No
- Do
- Don't know
- Other

Comments:

In our view, the key to an effective approach against aggressive tax avoidance would be full-inclusion CFC rules with a credit for foreign taxes paid. This would strongly deter profit shifting into untaxed entities, because it would ensure that to the extent that a payment is not taxed in the source country it would be included in the tax base of the receiving entity. However, certain types of hybrid mismatches would not be caught by CFC rules, such as double deductions or a deduction abroad with non-inclusion of the corresponding income in the parent country. Therefore additional rules to align classifications are indispensable. It is important that these rules cover all hybrid financial instruments (for example profit participating loans) as well as hybrid entities (for example with regard to transparent entities, permanent establishments, and entities whose place of effective management differs from the country of incorporation).

6.2 In the currently pending CCCTB proposal, the Commission has proposed a favourable treatment of costs for Research and Development (R&D) by making these costs fully deductible in the tax year they are incurred, with the exception of costs relating to immovable property.

What are your views on the existing framework for R&D?

- I support the existing framework for R&D
- I don’t support the existing R&D framework
- Don’t know
- Neutral
- Other X

One option for rendering the CCCTB more favourable to promoting R&D could be to introduce more generous provisions for deducting R&D costs, such as super deductions which are currently applied by a number of Member States (e.g. Croatia, the Netherlands and the UK)?

What are your views on making the existing framework for R&D more favourable?

- In favour
- Against X
- Neutral
- Don’t know
- Other

Comments:

Encouragement of R&D is widely accepted as a desirable aim of tax policy, and there is evidence that tax incentives are effective at both stimulating investment in R&D and producing innovation (European Commission study of 2014). Hence it seems desirable to allow deduction of R&D costs in the CCCTB. However, in our view they should be strictly limited to deductions for actual costs of inputs for research and development incurred by a

company and not deployed as a form of tax competition against other large economies around the world. It should also be borne in mind that there are many other ways to stimulate R&D which have broader positive effects on society and which do not undermine the tax base, from investing more public funds in the quality of higher education to governments becoming co-investors in research projects.

Hence, we oppose allowing excessive deductions for R&D costs, which will simply invite retaliation in kind with the result that all countries lose out. In our view also, tax incentives for R&D should be limited to allowances for actual expenditures on inputs and not favourable rates for income supposedly resulting from innovation. We strongly oppose special tax regimes, such as the so-called 'patent boxes' and 'innovation boxes' which have proliferated in the EU, and are now being taken up elsewhere. We see no justification for giving favourable tax treatment to one source of corporate income over others, or one type of innovation such as that producing patents rather than others. Such incentives are simply an encouragement to BEPS behaviour. The attempt to control such schemes by applying the 'modified nexus test' is resulting in complex and elaborate rules, which will only put a premium on sophisticated tax planning, disadvantaging SMEs which cannot afford the expense it entails, and diverting resources from actual R&D activity. In our view, all such special tax regimes need to be phased out across the EU.

7. Debt equity bias, Cross Border Loss Relief

7.1 Debt equity bias

Corporate tax systems usually favour debt-financing over equity-financing by treating interest payments as a tax deductible expense with no equivalent deduction for the return paid to equity.

Should debt bias be addressed in the proposal?

- Yes
- Know
- Neutral X
- Don't know
- Other

The corporate tax debt equity bias could be addressed via three possible policy options.

- Option 1 is the Comprehensive Business Income Tax (CBIT) that disallows any financing costs as deductible expense.

- Option 2 is the Allowance for Corporate Equity (ACE) that allows the deductibility of actual interest payments and of a notional interest on equity.

- Option 3 is the Cost of Capital Allowance (COCA) that allows the deductibility of a notional interest on capital (equity and debt).

In your view, which option would be best suited to address the corporate debt bias?

- Comprehensive Business Income Tax (CBIT) X
- Allowance for Corporate Equity (ACE)
- Cost of Capital Allowance (COCA)
- None of the above
- Don't know
- Other

We believe that the CBIT approach would marginally encourage equity and discourage debt. Given our potentially volatile economic environment, this would importantly contribute to economic stability. Further, since it would represent a considerable broadening of the tax base through the elimination of interest as a deduction, its adoption along with a lower general tax rate would yield the same amount of governmental tax revenues.

7.2. Temporary mechanism for cross-border loss relief

The Commission envisages proposing a temporary mechanism for cross-border loss relief with recapture until the consolidation step (CCCTB) is agreed. The aim will be to balance out the absence of the benefits of consolidation during the first step (CCTB) of the proposal.

What are your views on such a temporary mechanism for cross-border loss relief?

- In favour
- Against X
- Neutral
- Don’t know
- Other

Comment

We are particularly opposed to a 2-step approach which would allow cross-border transfer of losses in the first stage of a CCTB. This suggestion makes no sense in the absence of consolidation. Allowing firms to transfer losses in this way, while they would still state their accounts and declare profits on a national basis, has no justification. It would greatly disadvantage companies which invest only within a single member state, provide a tax incentive for cross-border investment, and increase the opportunities for tax avoidance for multinationals.

8. Final remarks

Its strong institutional framework provides the EU with the opportunity to take a lead and build on the BEPS project outcomes to establish an effective worldwide system to ensure that MNEs can be taxed where their economic activities take place and value is created. This is the only effective way to restore national sovereignty over taxation of income, since weak international coordination enables and encourages tax avoidance by MNEs, undermining public confidence in and the legitimacy of all taxes. Supporters of a federal EU might propose a single corporate income tax, but the CCCTB is a more realistic alternative, which preserves and indeed reinforces national state tax powers. A clear system which is easier to

administer than current complex international tax rules would also establish more certainty and a level playing field for all companies, helping to unlock the potential of the EU's enormous single market.