Tax Policy Alert

European Commission releases 'Communication on Business Taxation for the 21st Century'

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In brief

The European Commission released a "*Communication on Business Taxation for the 21st Century*" on 18 May, setting out its long-term vision and short-term legislative agenda. The aim is to align the EU tax framework with the new realities of the globalised and digitalised economy post-Covid, and to ensure that Member States' tax systems are fit for purpose. In the Commission's words: "*the EU needs* a *robust, efficient and fair tax framework that meets public financing needs, while also supporting the recovery and the green and digital transition by creating an environment conducive to fair, sustainable and job rich growth and investment*".

The Communication sets a tax agenda for the next two years with five key actions:

- Action 1: Table a legislative proposal for the publication of effective tax rates paid by large companies, based on the methodology under discussion in Pillar 2 of the OECD negotiations (by 2022)
- Action 2: Table a legislative proposal setting out union rules to neutralise the misuse of shell entities for tax purposes (ATAD 3) (by Q4 2021)
- Action 3: Adopt a recommendation on the domestic treatment of losses (alongside Communication)
- Action 4: Make a legislative proposal creating a Debt Equity Bias Reduction Allowance (DEBRA) (by Q1 2022)
- Action 5: Table a proposal for BEFIT (Business in Europe: Framework for Income Taxation), moving towards a common tax rulebook and providing for fairer allocation of taxing rights between Member States (by 2023).

The key points to note from the release are set out below.

In detail

Background

Long-term vision and priorities

The European Commission (EC) clearly aims to move away from reactive tax policy measures and to set out a vision and agenda for business taxation in the medium/longer term. The ultimate goal is creating an appropriate tax framework in preparation for major challenges, such as climate change and aging populations and to support post-COVID economic recovery. The EC's tax agenda is in line with wider EU policies, such as the European Green Deal, the EC's digital agenda, the New Industrial Strategy for Europe and the Capital Markets Union and the principles of the European Pillar of Social Rights.

The European Commission will carry out its work alongside the on-going discussions at the OECD Inclusive Framework on the taxation of the digital economy and minimum effective taxation.

The Communication claims that there is now consensus that the fundamental concepts of tax residence and source, on which the international tax system has been built, is outdated. The EC acknowledges that in recent years a 'patchwork' of anti-tax avoidance and evasion measures has been adopted which has increased complexity. The Communication indicates that the OECD Inclusive Framework's Pillars 1 and 2, even if international consensus would not be reached, provide the direction of travel. The EC wants to implement a robust, efficient and fair tax framework, and green and digital taxes are a part of that strategy.

Furthermore, the EC emphasises that tax systems will need to be modernised in order to be sustainable by shifting from labour taxes and social contributions to behavioural taxes (e.g., environmental and health taxes), property taxes and tax on capital for individuals and corporations. Labour taxes currently account for more than 50% of overall tax revenues in the European Union, but societal megatrends (such as an aging EU population and the rise of the gig economy) mean that labour taxes may become less reliable. As for VAT, the EC does not suggest increasing rates across the board, but revisiting reduced rates and exemptions.

Finally, the Communication outlines that not only is progress at EU level needed, but also support must be provided so that Member States can take national action with regard to the needs of their economy and society. The example provided here is the need for corporate income tax rates to be set above the minimum to be agreed internationally. The EU can also have an agenda-shaping and information-sharing role in supporting the Member States, as well as providing financial support for national reforms and investments.

New own resources and other supporting measures

The Commission has already made public details of the new 'own resources,' which will raise revenues to pay down debt post-COVID and fund the EU's NextGeneration plan and medium-term budget (2021 - 2027). The chief 'own resources' announced to date - the EU digital levy (announced as part of the Digital Decade Communication), the carbon border adjustment mechanism (CBAM) and the revised EU Emissions Trading Scheme (both green measures will be introduced as part of the Broader 'Fit for 55' package) - are closely aligned with the Commission's aims to promote a more green and digital EU economy. The communication also makes clear that the Commission will consider introducing an EU Financial Transactions Tax and also an own resource linked to the corporate sector. The Commission will take action to ensure that fraud, tax avoidance and tax evasion are minimised as part of the fair and effective taxation policy (see below). Currently, it estimates that billions of Euros are lost annually to tax fraud, evasion and avoidance. Transparency remains a key concern. Transparency and fair taxation will be promoted under the Tax Good Governance in the EU and beyond policy.

With regards to the digital levy, the Communication outlines that its design will sit outside of the OECD Inclusive Framework's Pillar 1 and be consistent with WTO obligations, but still 'coexist' with the Pillar 1 aim of 'sharing a fraction of the taxable base of the largest multinational enterprises.' The Commission is anticipated to release a full proposal on the digital levy on 14 July.

EU tax agenda in the face of the international corporate tax reform framework

Work continues by the OECD Inclusive Framework members to develop a global consensus-based solution to reform the international corporate tax framework, particularly given the increasing digitalisation of the economy. See our Tax Policy Alert for further details on the proposals under consideration by the OECD Inclusive Framework. This project has recently been reinvigorated as the US administration has re-engaged with the global forum, and the US has proposed measures that have potential to significantly increase the expected tax flows from this project.

The OECD Inclusive Framework's Pillar 1 and Pillar 2 Blueprints are in line with the Commission's vision for a 21st century business taxation framework. Regarding the tax reform plans of the OECD Inclusive Framework, the Communication notes that the Pillars mark steps towards the important principles of formulary apportionment and common definition of the tax base. The Commission intends to use the OECD Inclusive Framework plans to form the basis of future reform proposals for the Single Market (BEFIT) - see further below.

The European Union supports the OECD Inclusive Framework project and plans to implement the consensus-based solution shortly after its agreement later this year. The Communication outlines that Pillar 1 will be mandatory for participating countries and the rule will be implemented by way of an EU Directive. Pillar 2 will also be implemented by way of an EU Directive and will reflect the OECD Inclusive Framework rules but with necessary adjustments (the necessary adjustments may be substance-based carve outs to comply with the EU fundamental freedoms). This will ensure consistent application of the rules within the European Union and also ensure that the rules are compatible with EU law (as detailed further in the Communication). Facilitating Pillar 2 in this manner will also pave the way for agreeing the pending proposal for recasting the Interest & Royalties Directive (to ensure that the Directive's benefits are only granted where the payment is taxed in the destination state - whether a minimum tax rate would apply has not been determined). A Pillar 2 Directive may also have ramifications for the EU list of non-cooperative jurisdictions and could end up becoming one of the criteria against which third countries will be assessed. Furthermore the EU Commission acknowledges that the implementation of Pillar 2 will have implications for existing ATAD rules, 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 European Union, it will be necessary to explore how to best accommodate the interaction between the two rules.

Short term tax agenda

Section 3 of the Communication sets out the EU's business tax agenda for the next two years. The actions proposed will focus on ensuring fair and effective taxation with the promotion of productive investment and entrepreneurship.

Fair and effective taxation

Action 1: Table a legislative proposal for the publication of effective tax rates paid by large companies, based on the methodology under discussion in Pillar 2 of the OECD negotiations.

This measure will be actionable by 2022. This action will require the annual publication of the effective corporate tax rate of certain large companies with operations in the European Union, using the agreed Pillar 2 methodology (i.e., tax paid as a percentage of profits generated or 'book profits'). Certain difficulties are expected to arise in applying these methodologies such as use of different accounting standards for the 'book profit' starting point and

the extent to which taxpayer and tax authority agree on how to calculate the effective tax. The proposal does not specify whether the rates will have to be calculated at the country-level or at any other level.

Action 2: Table a legislative proposal setting out union rules to neutralise the misuse of shell entities for tax purposes (ATAD 3).

Although The EC notes that there can be valid reasons for the use of such companies, there is a need for further action to tackle misuse.This measure will be actionable by Q4 2021. A new legislative initiative will be introduced to neutralise the misuse of shell entities (with no or minimal substance and which exist for tax purposes only). The measure would include requiring companies to report to the tax authorities information to enable the tax authority to assess whether there is real and substantial presence and economic activity. Tax benefits may be denied where abusive shell companies are found to exist. Improved information exchange, monitoring and transparency would be required to facilitate such investigations.

In addition to these two actions, the Commission will also ensure companies pay a fair share of tax by applying and enforcing the EU State Aid rules.

Enabling productive investment and entrepreneurship

Action 3: Adopt a recommendation on the domestic treatment of losses.

This action involves the adoption of an EC recommendation to Member States on the domestic treatment of losses to ensure businesses are fully supported during the recovery. This measure is intended to benefit SMEs. The Commission will also investigate more generally the prospect of a coordinated treatment of cross-border loss relief to address challenges experienced by SMEs and other businesses in the initial stages of their European expansion.

Action 4: Make a legislative proposal creating a Debt Equity Bias Reduction Allowance (DEBRA).

This measure would be actionable by Q1 2022. There continues to be a pro-debt bias when businesses consider how to fund their activities and growth plans. This is driven by the ability to deduct interest and other financing costs from taxable profits (there is no equivalent deduction granted for equity investments or dividend payments). The communication states that this issue has become more pressing, as companies' debt levels have increased significantly due to the economic crisis following the COVID-19 pandemic.The Commission will therefore make a proposal to address this debt:equity bias via an allowance system for equity financing (subject to appropriate anti-avoidance rules).

Action for a longer-term business taxation framework

Action 5: Table a proposal for BEFIT (Business in Europe: Framework for Income Taxation), moving towards a common tax rulebook and providing for fairer allocation of taxing rights between Member States

The EC's ambition is clearly far-reaching. The EC has stated that a closely integrated European Union should be able to go further than implementing a global agreement on Pillar 1, because a Pillar 1 agreement will apply to a limited number of companies at the outset. For such a solution to work globally, it needs to be administrable for and among 139 jurisdictions, with diverse economic profiles and levels of administrative capacity.

With that in mind, and as expected, the Communication includes details of a re-branded Common Consolidated Corporate Tax Base (CCCTB), which will be known as 'BEFIT' (Business in Europe: Framework for Income Taxation).

The aim here is to leverage from the Pillar 1 framework 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)”. BEFIT will use a formula for allocating profits as well as common rules for calculating the tax base. It will remove undue tax barriers which limit the EU’s overall competitiveness, but leave sufficient scope for revenue generation with Member States so that they may fund national spending priorities. BEFIT will replace the CCCTB proposals which are now to be formally withdrawn.

> “BEFIT will…
> …create a common rulebook for groups of companies operating in the Single Market in more than one Member State, reducing barriers to cross-border investment;
> …reduce red tape and cut compliance costs in the Single Market, thereby lessening the administrative burden on tax authorities and taxpayers;
> …combat tax avoidance, and support job creation, growth, and investment;
> …provide a simpler and fairer way to allocate taxing rights between Member States; …ensure reliable and predictable corporate tax revenues for Member States.”

The mechanics of BEFIT involve consolidating the profits of a MNE’s EU members into a single tax base, allocating that tax base to the Member States using the appropriate formula, and taxing the allocated profits at the national corporate income tax rate. The considerations when deciding profit allocations are expected to reflect the considerations that have arisen as part of the Pillar 1 profit allocation discussions. Apportionment factors to consider will include sales in the market, assets (including intangibles) and people in a location. The allocation keys for both Pillar 1 and BEFIT profits are likely to be very different and it is not yet clear how such differences may be resolved.

Overall, the Commission expects that this system will simplify the calculation of taxable profits and taxes within the European Union, and accordingly remove the need for complex transfer pricing rules. Interestingly, however, they do not address the previously contentious issue of the treatment of losses. The BEFIT formulary apportionment rules will replace the current rules for the allocation of a taxable base within the Single market for in-scope companies. This proposal is similar to the CCCTB and the Communication notes that both BEFIT and CCCTB follow the same guiding principles, but there is a sense from the EU Commission that there is a greater likelihood of this proposal being successfully implemented given the changes in the economy since CCCTB was originally proposed in 2011 and given the status of the OECD Inclusive Framework project.

The takeaway

The Commission’s Communication was long-awaited and clearly indicates the EU’s desired future of business taxation. In some cases, piecemeal announcements over the last few months have been brought together in this communication and the principles and policy rationales underpinning these measures are now clear. Notably, this communication marks the EC’s third attempt in a decade to pivot the Member States towards a common corporate tax base. While the international tax landscape has moved on since the last CCCTB proposal failed to move forward, ultimately the same concerns need to be addressed - the issue of unanimous voting on tax matters, tax sovereignty and achieving a system that is perceived as fair and workable by all Member States.

The breadth of the changes is significant and it seems likely that the proposed changes will impact taxpayers with EU activities. Accordingly, taxpayers should review the Communication, and discuss with your usual PwC contact who can provide you with further information and contextualise the announcements for your business.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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