The **BEPS**

Monitoring

Group

COMMENTS ON

The European Commission's Proposals for a CCTB and for a CCCTB

The BEPS Monitoring Group (BMG) is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This report has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. It has been prepared by Sol Picciotto, with comments and input from Tommaso Faccio, Jeffery Kadet and James Stewart.

A. The Need for a New Approach

The Commission has rightly recast the proposal for a Common Consolidated Corporate Tax Base (CCCTB), so that it is no longer merely aimed at enabling companies to operate more easily within the single market, as was the previous version of 2011. The present proposal[1] is for 'a new framework ... for a fair and efficient taxation of corporate profits' based on 'an effective tool for attributing income to where the value is created'. It now aims to tackle head on the inadequacies of international tax rules, which not only allow but in practice encourage tax avoidance by multinational enterprises (MNEs).

In our view, however, the aim should be to create a level playing field in relation to tax on corporate profits not only within the EU but worldwide. Unless this is done, EU member states will continue to compete with each other to offer tax preferences to MNEs from outside the EU. They will also continue to be vulnerable to tax competition from jurisdictions not covered by the CCCTB (including the UK, after Brexit). The CCCTB can and should be recast so that it attributes to the EU as a whole a portion of the worldwide profits of MNEs reflecting their actual activities within the EU, as well as allocating that profit among EU states, using the same criteria.

The EU can and should take a lead on this issue at this juncture. The G20/OECD project on base erosion and profit shifting (BEPS) made an enormous effort to repair international tax rules. Its outcomes could significantly strengthen the powers of national tax administrations.

[1] For tactical reasons, the Commission has separated it into two: a draft Common Corporate Tax Base (CCTB), in COM(2016) 685, and another to provide for consolidation (and apportionment) (CCCTB), in COM(2016) 683. We refer to the two together as the CCCTB.

The EU has acted promptly to ensure the adoption of many of the proposals within the EU on a common basis.

However, these measures are only palliatives. The BEPS project has so far failed on the central challenge, to provide clear and agreed criteria for allocating the profits of MNEs to 'where economic activities occur and value is created', as requested by the G20 world leaders. Work is still continuing on the key issues of the profit split method for transfer pricing, attribution of profits to permanent establishments, and the tax challenges of the digital economy. However, it is not clear that the political will that helped initiate the two-year BEPS process can be found today for a strengthened multilateral approach through the G20.

Instead, we see a growing threat of unilateralism. Already before the BEPS project was completed, the UK in 2015 enacted its diverted profits tax (DPT), and similar measures have since been proposed in Australia and New Zealand. It is a concern that such leading OECD countries have felt it necessary to adopt such provisions. Nevertheless, they are understandable as pre-emptive measures, due to the failure especially of the US as well as other states to ensure fair taxation of the foreign profits of MNEs based in those countries. The European Commission has itself been criticised for initiating action under the state aid rules against tax advantages granted to MNEs by some states. A key motivation for such initiatives has been the major gap created in international tax rules by the exploitation by many MNEs of the opportunities for achieving low effective tax rates by deferring or avoiding tax on foreign profits.

Now reform proposals are under consideration in the US, which could be facilitated by the political alignment of a Republican president and a majority in Congress. These also seem likely to take a unilateralist approach. Most worrying is the proposal, adopted by House Republicans in June 2016, for a destination based cash flow tax (DBCFT). This has theoretical support from some economists, including some in Europe.[2] However, it would have a strongly protectionist effect on trade, due to its 'border adjustment' element, i.e. allowing deduction of domestic production costs, but no deduction for foreign costs or the costs of imports. It would therefore quite clearly be a violation of WTO rules, which could result in permitted counter-measures. Since this could lead to a trade war, as well as a major revaluation of the US dollar, it is obviously to be hoped that such a course will not be chosen. Nevertheless, a US corporate tax reform is very probable within a year at most, and is likely to include permitting repatriation to the US of low-taxed profits held offshore, subject to a relatively very low US tax.

Now is clearly the time for a strong and united initiative from the EU. This could be provided by a modification of the CCCTB proposal. It could be formulated in a way which would be substantially compatible with existing international tax principles, and without a protectionist impact on trade and investment. We believe also that it can be designed to counteract any US tax measures that would discriminate between importing and exporting companies. This would be more effective and less disruptive than retaliating through trade sanctions under the WTO. In this way the EU could take a lead in moving away from existing systems that so motivate profit shifting and towards global rules for taxation of MNEs which could be much more effective, and widely accepted as fair. Such a proposal would command widespread

[2] Auerbach, Devereux, Keen, and Vella, J (2017) Destination-Based Cash Flow Taxation. OUCBT Working Paper 17/01. Several papers by leading US commentators evaluating the proposal were published in a special issue of the Columbia Journal of Tax Law in April 2017, available at https://taxlawjournal.columbia.edu/article/a-guide-to-the-guide-to-the-republican-better-way-plan/

public support, and help to re-establish a momentum for effective concerted action by EU states at a time of crisis for the EU project. It would also restore effective national sovereignty to tax MNEs where their real economic activities occur. Since existing approaches have failed to do so, it would comply with the principle of subsidiarity.

B. Reformulation of the Proposals

The CCCTB adopts a sound approach to taxation of MNEs, by treating them in accordance with their business reality as unitary firms. It aims to identify the tax base of the whole corporate group, disregarding internal transactions between the affiliates, and to apportion the taxable profit according to factors reflecting the firm's real activity (sales, assets, employees) in each country. This is the most effective way to end both competition between states to offer tax incentives, and tax avoidance by MNEs shifting income between affiliates to minimise tax.

Extended CFC Rules

Unfortunately, however, the draft proposal applies this principle only to the affiliates and branches (permanent establishments) within the EU. It contains only limited measures to prevent shifting income to affiliates outside the EU. The main provisions to prevent this are those on controlled foreign companies (CFCs), which in the CCTB draft (article 59 of COM(2016) 685) are similar to those in the ATAD-I. They apply to entities which are low-taxed (in effect, below 50% of what would have been paid by the owner), and only in respect of 'passive' earnings.

Consideration could be given to extending these provisions to include **all** the foreign income. This would go beyond the recommendations in the report on Action 3 of the BEPS project, but would not be contrary to those recommendations. It could also be seen as valid under existing international tax treaty rules. Such an approach to CFCs could protect the tax base of both the country where the CFC is located and that of its owner. In order to achieve this, there should be an apportionment of the aggregate income (of the CFC and of its owners), applying the formula in the CCCTB. Thus, the jurisdiction of the CFC would be free to offer a low tax rate or any other preferences, but it would be effective for EU purposes only in relation to the income deriving from the group's real activities within that country, as reflected in the apportionment formula. (The actual taxes imposed by the jurisdiction would of course be defined solely by its own sovereign laws and not be affected by the EU CCCTB provisions.) This apportionment would identify the tax base and the foreign tax credit limitation that could be used under the CCCTB in defining taxes paid to EU member countries in respect of operations attributed to CFCs outside the EU. This mechanism will eliminate the present motivation to shift profits out of the EU that exists under EU member state systems which exempt foreign income.

However, to be fully effective, this would need a broader approach. In the current proposals, the definition of a CFC requires its owner to be a taxpayer within an EU member state (article 59.1.a). This leaves open possibilities for avoidance, especially by MNEs with an ultimate parent outside the EU. To prevent this, the CFC definition should at least be amended to apply to all entities under common ownership and control.

Adopting a Worldwide Tax Base

More broadly still, consideration should be given to a new approach to the definition of the tax base for the CCCTB. The approach chosen by the Commission, since the development of the 2011 proposals, is that the financial accounts of each of the national entities of a MNE group within the EU should first be adjusted, separately, by applying the tax base definitions

in the CCTB. These separate accounts are then aggregated to produce the total tax base which is to be apportioned.

This is not a true consolidated tax base. A worldwide approach would be significantly easier to adopt for MNEs and tax authorities alike if the starting point were the consolidated financial accounts of the MNE as a whole, which could be adjusted according to the tax base definitions of the CCTB.

Starting from the global consolidated accounts has a number of significant advantages.

First, these are audited accounts. Separate accounts of group members may or may not have been subject to rigorous audits by outside qualified accountants.

Secondly, consolidated accounts reconcile the accounts of the various affiliates and in that process eliminate all intercompany transactions that often distort and shift profits between group members. Under the current draft CCCTB, each affiliate's accounts would be prepared separately under the relevant national accounting rules, permitting the recognition of intercompany transactions that may not be treated the same in each country, thereby allowing arbitrage between group members and countries. Such intercompany transactions are not required to be reconciled. This is a major reason why starting from group consolidated accounts is a much better basis for apportioning group profit.

Thirdly, starting from group consolidated accounts would greatly facilitate the approach we strongly recommend, which is to begin by apportioning the global profit between the EU and non-EU activities, applying the formula in the CCCTB for that apportionment. In our view, this is essential for the CCCTB to work effectively. The present proposal would not deal adequately with the threat of profit-shifting outside the EU, since it relies on current international tax rules, which are a major part of the problem and are not the solution.

It should be stressed that our suggested approach would apply only to MNEs with a legal business and/or a taxable presence in a member state of the EU, as that will provide the basis for the assessment, enforcement, and collection of taxes due. Note that the obligation to submit worldwide consolidated accounts would apply to non-EU-based MNEs in the same way as in the draft CCCTB, but in this case to the highest tier affiliate within the EU. This is defined as the 'principal taxpayer' in the current proposal (COM (2016) 683, article 3.11, article 51). However, in our view this definition should be strengthened, to specify that the 'principal taxpayer' is the entity in the member state where the group's highest tier of management within the EU is located. There would be no question of assertion of 'extraterritorial' jurisdiction since the taxpayers will solely be the various group members that are, in fact, taxable in a member state due to their local business activity and taxable presence. The use of worldwide consolidated accounts to provide the basis for apportionment, thereby determining the local tax base for each group member, does not change this.

Apportioning the Tax Base

Our proposal would entail an apportionment of the worldwide tax base amongst all jurisdictions. To prevent avoidance and artificial schemes, the apportionment mechanics should include an appropriate 'throwback' provision for any tax base that would otherwise be assigned to a jurisdiction in which there is no MNE group member that has a taxable presence. In general, the same formula factors should be applied, and the same procedures followed as in the draft CCCTB (Chapter VIII).

This would be the most effective way of preventing profit shifting by MNEs not only within the EU between member states, but perhaps more importantly outside the EU. It would remove the incentives under the current system for MNEs to create complex corporate

structures, often involving many intermediary entities in low-tax countries. It would also neutralise the effects of harmful tax practices by states.

Countries would remain free to aim to attract investment based on their genuine advantages, such as geographic location, nature of workforce, infrastructure etc. They could also choose their own headline corporate tax rate, which could become a factor of competition. However, this would be far less damaging than the present competition over tax base definitions, which produces negative spill-over effects on other countries. A low tax rate under the global CCCTB would affect only decisions on location of real activities, as reflected in the apportionment factors (assets and employees, since sales depend on the location of customers[3]). If countries where MNEs have a substantial presence wish to consider lowering their tax rate, they would have to balance the revenue losses against any benefits from investment.

This approach would result in some significant changes in allocation of the tax base of MNEs. First, we anticipate that the apportionment of tax base under the worldwide CCCTB that we propose would importantly result in a reallocation from countries—often tax havens—where MNEs have no significant activities (production or sales). This of course would most affect those MNEs that have been relatively more aggressive in their tax structuring in comparison with more conservatively managed MNEs. This would have the beneficial effect of leveling the playing field for all competing firms. It should also be borne in mind that MNEs would benefit significantly from the cross-border pooling of losses which is an automatic corollary of consolidation and apportionment. Hence, it is likely that some MNEs, especially those that have been conservative in their tax planning, could see an overall reduction in their global effective tax burden.[4] There would also be a very significant reduction in compliance costs for MNEs and governments alike, especially in relation to tax avoidance through transfer pricing, which would be completely blocked due the elimination of all inter-company transactions on consolidation. There would also be a significant reduction in the complexity of international tax rules dealing with key issues such as residence or characterization (e.g. hybrid entities or instruments), and source of income.

In our view, adoption of such a global CCCTB would create an incentive for other countries to move to a similar approach. The apportionment formula of the CCCTB strikes an appropriate balance between production factors (employees and assets) and consumption (sales),[5] and hence between the incentives for investment and the effects on tax revenues. The EU has the opportunity to be a real leader that will set the tone for the future of international taxation.

In the near to mid-term, there will of course continue to be major countries (such as the USA, Japan, China, etc.) that will continue with their present separate legal entity-based taxation systems. The USA is currently discussing corporate taxation based mainly or entirely on the location of sales, as with the DBCFT. The EU's application of a global CCCTB allows all such countries to exercise their sovereignty in designing and maintaining their own systems. For example, the USA might choose to exempt from tax MNE profits earned from production

[3] While the location of real customers is not controllable, there undoubtedly will be game-playing by some MNEs to manage the location of sales through re-invoicing and other arrangements with non-group members. This could be dealt with by applying anti-abuse rules.

[4] See the estimates by Cobham, Jansky and Loretz which indicate that pooling of losses and profits would result in an average reduction of the tax base of 11-12%, but that this would be offset by the ending of profit-shifting to low-tax countries (in Picciotto, ed., *Taxing Multinational Enterprises as Unitary Firms.* International Centre for Tax and Development, (2017), p. 106-7.

[5] We would prefer a formula with a 50-50 split of employees (weighted equally between payroll costs and headcount, as with the current draft) and sales, since assets are notoriously hard to value accurately.

in the USA where the location of sales are outside the USA, but any such sales made into EU member states where the MNE has a taxable presence would increase the apportioned profits within that member state. Further, a 'throw-back' rule would add back to all jurisdictions both within and outside the EU any sales to jurisdictions where the MNE has no legal business or other taxable presence.

Compensation Mechanism

There are important effects on EU MNEs that could result from the adoption by another major state such as the USA of sales-based taxation such as a DBCFT. One effect is that such MNEs with substantial sales in that state without significant local production costs would economically face a heavier tax burden there.

Where an EU-based business sells its products to an unrelated USA importer, that importer will legally bear the higher tax and will likely exert pressure on the EU business to lower its prices, thereby partially offsetting its higher tax costs. On the other hand, when an EU-based MNE has its own distribution operation in the USA that buys and resells to customers, then that MNE's USA group members will legally bear the higher level of taxation.

We do not suggest that any EU or member state tax mechanism be used to address anticipated pricing pressures on sales by EU businesses to unrelated US importers. We do not believe that this is appropriate or practical. We do, though, suggest that each EU member state consider whether it wants to allow MNEs based in that member state to include the income and expenses of their operations in the USA (and any other jurisdictions applying sales-based taxation) in the member state's tax base, thereby treating those operations as if they had been conducted by a tax resident of that member state. Doing so would allow the application of some amount of foreign tax credit for actual US taxes paid not only on the sales and distribution activities occurring in the USA, but also on production and other activities occurring in the member state.

Under the principles of most foreign tax credit regimes, the foreign tax credit limitation formula does not allow any foreign taxes to be applied as tax credits against tax on profits from activities in the home country. A member state could choose, if it so desires, to allow an adjustment to that formula that would allow a tax credit for a part (say, 50%) or even all of the additional USA taxes actually paid that relate to profits on activities occurring in the member state.

A second effect is that MNEs with sales in the EU but producing mainly in the foreign state (e.g., the USA) would be taxed very lightly or not at all by that foreign state. In such a case, the apportionment formula could be adjusted to eliminate the factors for assets and employees located in that foreign state. Doing so would increase the tax base apportioned to the other countries where the MNE operates, including EU member states and non-EU member states, to compensate for the exemption of export revenues from the tax base of the state applying the DBCFT with border tax adjustment. This would thus ensure taxation of the profits not taxed by the state applying a DBCFT by all countries that adopt the worldwide apportionment approach. The adoption of this worldwide formulary approach by EU member states will encourage other countries to adopt a similar approach.

C. Other Limitations of the Proposals

We would also like to draw attention to several significant defects in the current proposals. Our comments in this section are in line with those made by others, notably Business Europe.

The 2-step approach

Under the suggested two-stage approach, the first stage would simply entail adoption of common tax base definitions, with no reallocation or apportionment of profits or losses. In our view, this makes little sense. The two aspects should be treated as a single proposal.

However, it is made even more senseless by allowing transfer of losses in the first stage. This would give MNEs the benefits of the full CCCTB, without having to accept its full implications. Hence, it would also make it more difficult to gain support for a move from the first to the second stage. To allow pooling of losses without apportionment of profits is incoherent.

The Tax base definitions

Two measures are included which would significantly narrow the tax base, with differential effects on different companies and economic sectors. This is bad tax policy. It is far preferable to adopt a broad tax base, and aim for cuts in rates. The main merit of cash-flow taxation (disregarding the border adjustment) is that it starts from a wide tax base, allowing immediate expensing of actual investment (including on R&D) and production costs, but not of interest. A similar approach should be adopted in the tax base definitions of the CCCTB.

Hence, we disagree with the proposal for an Allowance for Growth and Investment (AGI). This is justified by the claim that there is excessive leverage or excessive use of debt finance by EU based companies.[6] The analysis is based on the Griffith-Devereux model of corporate financing and investment decision making, which in our view is seriously flawed. In brief, the assumption of this model is that the aggregate tax behaviour of a firm consists of the sum of individual projects in different sectors across different countries. Investment decision making is based on discounted cash flows which are assumed to be known with certainty. One obvious flaw is that investments that do not produce cash flows such as R & D cannot be analysed in this way. But the major flaw is that tax policy for a MNE is determined at the aggregate level of the firm. Well known examples are Apple and Alphabet (formerly Google). For instance, Apple operates in numerous countries across many sectors, but declares more than 60% of its aggregate profits in Cork which determines its tax payments overall. The Griffith-Devereux model takes no account of this standard pattern, so it is an inadequate basis for justifying the AGI.

In reality, corporate finance decisions are complex, a function of asset structure, size of firm, and shareholder structure. For example IP intensive firms, particularly new firms, are less reliant on debt finance than other firms. Dominant shareholders may be reluctant to issue external equity because of dilution of control, and reluctant to commit extra equity because of excessive portfolio concentration, hence a greater reliance on debt finance. Information asymmetries have been long recognised as a reason for debt finance. The problem for innovative young firms is not excessive debt, but rather the inability to raise any external finance, hence the initiative to establish the European Fund for Strategic Investments. ECB data does not indicate over gearing by EU based firms except in the banking sector where tax deductibility is not the issue.[7]

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[6] See CCTB proposal p. 10. The rationale is contained in Taxation Papers, Working paper no. 65, 2016, p.9.

[7] The ECB says that net issuance of debt securities increased between 2009 and 2014 due to 'increasingly favourable market financing conditions', while 'during the crisis firms financed a larger share of their activities with internally generated funds and higher retained earnings' (ECB Economic Bulletin, Issue 5/2016, pp. 30 and 31-32, available at https://www.ecb.europa.eu/pub/pdf/other/eb201605_focus05.en.pdf). In addition Moodys data shows that non-financial firms in EMEA increased their cash balances by 40% since 2008-09.

Starting from the global consolidated accounts, as we suggest, means that only actual third-party interest costs of the MNE as a whole could be deducted. It may be desirable to go further, and end deductibility of interest, as many economists have long advocated, and is proposed in the DBCFT. But in our view there is no justification for the AGI, which would in practice complicate and distort investment decisions.

Secondly, we are opposed to the suggested super-deduction for R&D. Immediate expensing of 100% of R&D costs is already a generous approach. It is justifiable to allow such deduction of actual expenditures, and available evidence shows positive benefits. However, the super-deduction would in effect amount to a selective subsidy, across the whole of the EU, delivered through the tax rules. This cannot, in our view, be justified by principles of fairness, nor in terms of the effects on stimulating innovation by all entrepreneurs.

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