Euro Tax Flash

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Euro Tax Flash from KPMG's EU Tax Centre

Commission Package on Common (Consolidated) Corporate Tax Base, hybrid mismatches and dispute resolution.

Corporate tax package – Common Corporate Tax Base – Common Consolidated Corporate Tax Base – Hybrid mismatch arrangements – Dispute resolution

On October 25, 2016 the European Commission published legislative proposals to relaunch its Common Consolidated Corporate Tax Base initiative, as well as new measures to combat hybrid mismatches, including those involving non-EU countries, and to improve the existing procedures to resolve disputes involving double taxation within the EU.

Background to the CCCTB and CCTB relaunch

In March 2011 the European Commission (EC) launched a proposal for a Common Consolidated Corporate Tax Base (CCCTB) (see the KPMG Guide to CCCTB). This envisaged an optional system for companies to apply a common set of rules to compute taxable profits, including the ability to form a consolidated group, wherever they were based in the EU. Its main objective was to facilitate cross-border business activity within the EU.

The discussions between EU Member States since 2011 made clear that there was not sufficient support for adopting the CCCTB proposal in its entirety. In its Action Plan of June

2015 the EC therefore announced that it would relaunch the CCCTB project in 2016, introducing a two-step approach (see ETF 253; see also ETF 260). Under this approach, Member States should first agree on rules for a Common Corporate Tax Base (CCTB), after which agreement should be reached on the consolidation element. Neither the original proposal nor the current proposals involve changes to Member States' corporate tax rates.

Relaunch of CCCTB/CCTB

The relaunched proposals consist of two separate draft directives, one for a CCTB and the other for a CCCTB. If approved by all EU Member States, the CCTB proposals would apply from 2019 and the CCCTB proposals from 2021.

Under the new proposals the focus of attention has moved from the objective of simplifying compliance to facilitate cross-border investment to countering tax avoidance. The Explanatory Memoranda refer to the current rules for corporation tax no longer being fit for the modern context and the need for a "fair and efficient taxation of corporate profits". The draft directives contain provisions which are intended to mirror the measures that were included in the Anti-Tax Avoidance Directive (ATAD) that was adopted in July 2016 (see ETF 289). However, in order to ensure a more harmonized implementation, the new proposals give Member States less flexibility to apply stricter rules than required by the ATAD. Unlike the 2011 proposal, the new rules (both CCTB and CCCTB) would be mandatory for large corporate groups, i.e. broadly, with consolidated revenue exceeding EUR 750 million. The system would be optional for other companies. According to the EC, this would limit the risk of domestic groups falling under the mandatory system. The proposed rules would generally be limited to EU-resident companies and permanent establishments (PEs) situated in the EU. An extensive definition of EU (but not third country) PEs is provided, which largely follows the OECD BEPS definition.

Some notable aspects of the two proposals, including important deviations from the 2011 proposal, are set out below.

CCTB proposal

The CCTB proposal provides rules for calculating the corporate tax base, including anti-tax avoidance rules. Unlike the 2011 proposal, administrative provisions are limited to notification procedures. In other respects, taxpayers would continue to fall under their national administrative provisions. As proposed in the 2011 proposal, realized income is, in principle, taxable unless specifically exempted or reduced by deductible expenses and other deductible items.

Other aspects of the proposal include:

- Temporary loss relief for direct EU subsidiaries and EU PEs
  In order to compensate for the absence of the benefits of cross-border consolidation during the first step, the CCTB proposal provides for temporary loss relief with recapture. This means that losses incurred by a direct group subsidiary or PE in another Member State can be deducted by the parent company, but will be recaptured when subsequent profits are made, or otherwise after five years.
- Allowance for Growth and Investment
  Unlike the 2011 CCCTB proposal, the CCTB proposal includes a rule against 'debt bias', i.e. the asymmetry whereby interest is deductible whereas profit distributions are not. Taxpayers will be given a deduction, referred to as an Allowance for Growth and Investment, or 'AGI', in respect of a defined yield on specified increases in their equity. This will be deductible from their taxable base subject to certain conditions, such as measures against potential cascading effects and anti-tax avoidance rules. As a result, the tax value of participations in associated enterprises are excluded from the AGI base. Decreases in equity will result in a corresponding addition to the tax base.
- Enhanced deductions for R&D costs

As was proposed in 2011, research and development (R&D) costs are in general deductible in the year these are incurred. However, under the new proposal, taxpayers will also be entitled to a 'super deduction' of an extra 50% for R&D expenditure up to EUR 20 million and 25% for expenditure above this level. An enhanced 100% extra deduction would be available for start-ups for R&D expenditure up to EUR 20 million. The CCTB does not provide for a patent or innovation box.

- Participation exemption and switch-over clause
  As was proposed in 2011, the new proposal contains an exemption for dividends and proceeds from the disposal of shares. However, unlike in 2011, the new proposal would limit the exemption to 10% shareholdings that have been held for a minimum of 12 months.
  The new proposal, like the 2011 proposal, also contains a switch-over clause under which Member States must apply a credit instead of an exemption system for certain income derived from low-taxed entities in third countries. The switch-over clause is similar to, but somewhat broader than, the one that was finally dropped from the ATAD. For the application of the switch-over under the CCTB it is irrelevant whether the foreign income arises from an active business. (see ETF 285 and ETF 289).
- General Anti-Abuse Rule
  The 2011 proposal contained a General Anti-Abuse Rule (GAAR). However, the GAAR in the new proposal is drafted in line with the corresponding provision in the ATAD (see ETF 289), in contrast to the GAAR in the original proposal.
- Interest limitation rule
  This is a new rule, which is similar to the interest limitation rule in the ATAD (see ETF 289). Under this new rule, interest and other financial costs are explicitly deductible to the extent that they can be offset against taxable interest and other financial revenues. Any surplus will generally be deductible up to a maximum of 30% of the taxpayer's earnings before interest, tax, depreciation and amortization (EBITDA). Unlike the ATAD, the CCTB proposal does not contain an option for Member States to apply a worldwide 'group escape' rule.
- Controlled foreign companies (CFC) rules
  The CFC rules in the new proposal are significantly different from those proposed in 2011. Like the ATAD, the new rules apply to entities and PEs that constitute CFCs in Member States as well as in third countries. While the CFC definition essentially follows that of the ATAD (see ETF 289), the 'substance' carve-out has been amended and the scope of the rules has been restricted by limiting them to specified passive CFC income.
- Hybrid mismatch rules
  Although hybrid mismatches should in principle no longer arise under the CCTB, this would not necessarily be the case as regards the interaction between the CCTB and national Member State or third country tax systems. The new proposal therefore sets out comprehensive rules for hybrid mismatches. These reflect the corresponding provisions in the ATAD (see ETF 289), but go further to cover mismatches in relation to third countries, as well as mismatches involving permanent establishments, imported mismatches, hybrid transfers and dual resident mismatches.
- Exit taxation
  The CCTB proposal contains an exit taxation provision similar to the one in the ATAD (see ETF 289). However, unlike the ATAD, a tax deferral mechanism for transfers within the EU/EEA is not included.
- Losses
  As was proposed in 2011, losses may be carried forward without any limitation, but carry-back is not possible. However, the CCTB proposal also contains an anti-abuse provision to discourage the circumvention of the rules on loss deductibility through purchasing loss-making companies.

CCCTB proposal

The CCCTB proposal lays down the conditions for the formation of a consolidated tax group and sets out the mechanism for allocating the consolidated tax base to the respective Member

States ('formulary apportionment'). It also provides rules for entering and leaving a group, including the treatment of losses. There are also anti-avoidance provisions to prevent abuses of the consolidation and apportionment systems, e.g. involving business reorganizations and the intra-group transfer of assets. Special provisions would adapt the CCTB rules to groups that become subject to the CCCTB rules, so that, for example, the interest limitation rules would be applied by reference to the CCCTB group.

Consolidation would only be mandatory for large groups and, like the CCTB rules, would be effectively limited to EU-resident companies and PEs situated in the EU. A group can, in principle, involve non-EU resident companies, but only their EU PEs would be eligible for consolidation. Groups that do not meet the size threshold would be allowed to opt for the consolidation rules. Group subsidiaries (direct or indirect) are defined by reference to control (50% voting, and 75% capital or profit).

The formula for apportioning the positive consolidated tax base is effectively the same as that proposed in 2011, i.e. on the basis of three equally-weighted factors: labor, assets and sales. With respect to the asset factor, it is interesting to note that, as in the 2011 proposal, intangible assets are excluded from the base of the asset factor. Where a consolidated loss arises, this is carried forward and set off against the next positive consolidated tax base. As was the case in 2011, there are detailed administrative provisions for consolidated groups. Groups will deal with one tax administration in the EU ('one-stop-shop'), which is usually the Member State where the group's parent company is resident.

Proposals on hybrid mismatch arrangements

The proposed directive to amend the ATAD as regards hybrid mismatches follows the corresponding provisions in the CCTB proposal. If adopted, the new provisions would apply from 2019, i.e. in line with the main provisions of the current ATAD. As already noted, the hybrid provisions would not only apply to mismatch arrangements within the EU, but also to mismatches arising in relation to third countries. They would also deal with mismatches involving permanent establishments, imported mismatches, hybrid transfers and dual resident mismatches.

For hybrid entities and instruments as between Member States, the proposals are in line with those in the ATAD. For hybrid PEs between Member States, whereby a payment is not recognized as income in the state of residence nor the state where the PE is situated, the mismatch is resolved by requiring the state of residence to tax. The general principle underlying the proposals for resolving mismatches in relation to third countries is for the Member State to align its tax treatment with that of the third country unless the mismatch has already been eliminated by the third country.

Proposals to improve dispute resolution

In its explanatory documents accompanying the new proposals, the EC points out that double taxation has a negative impact on cross-border investment and leads to economic distortions and inefficiencies. Disputes between Member States on how to eliminate double taxation therefore need to be solved. While for companies within the CCCTB system, double taxation should be significantly reduced, issues may still arise with non-EU companies or companies outside the CCCTB system. The EC also points out that the EU Arbitration Convention on the elimination of double taxation has substantial shortcomings regarding access for taxpayers to those mechanisms, coverage, timeliness and conclusiveness. Moreover, the traditional methods of resolving disputes no longer fully fit with the complexity and risks of the current global tax environment. The current proposals therefore include a draft directive to improve these mechanisms within the EU. The intention is that the new rules will have a wider scope, be more effective, work quicker and be less costly.

EU Tax Centre comment

As noted in KPMG's response to the EC's 2015 public consultation on CCCTB, although there are areas of concern, KPMG is broadly supportive of the proposed rules, in particular insofar as a single set of tax rules could be a key element in reducing the administrative burden of complying with up to 28 different tax systems in the EU. The new proposals also reflect our recommendation to make the new rules at least in part optional, as well as introducing an incremental deduction for R&D.

We note that the EC is following a practical strategy by first introducing a CCTB. As we pointed out in our response to the consultation, the consolidation element is a sensitive point for Member States, in particular as regards the allocation formula, which is unchanged from the original proposals. The failure to generally recognize intangible assets in this context is particularly striking and we can expect continued political debate on this aspect going forward. The CCTB initiative remains a major challenge for Member States as well as for the business sector, and it is questionable whether the required political unanimity will be reached, especially within the projected timeframe. A lot of work still has to be done to improve the technical side of the proposals, including a more detailed explanation in order to avoid differing implementation in the 28 EU Member States.

The proposed extension of the anti-hybrid rules in the ATAD and the equivalent rules in the draft CCTB Directive replace and build on existing 'soft law' guidance and should assist in a coordinated implementation of the corresponding OECD recommendations under BEPS Action 2.

The proposed improvements to the dispute resolution procedures go some way to meeting the concerns expressed in KPMG's response to the EC's public consultation in the first half of 2016 (see ETF 281). In particular we welcome the proposal to allow taxpayers to request their national court to initiate a binding arbitration procedure within a set timeframe.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

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