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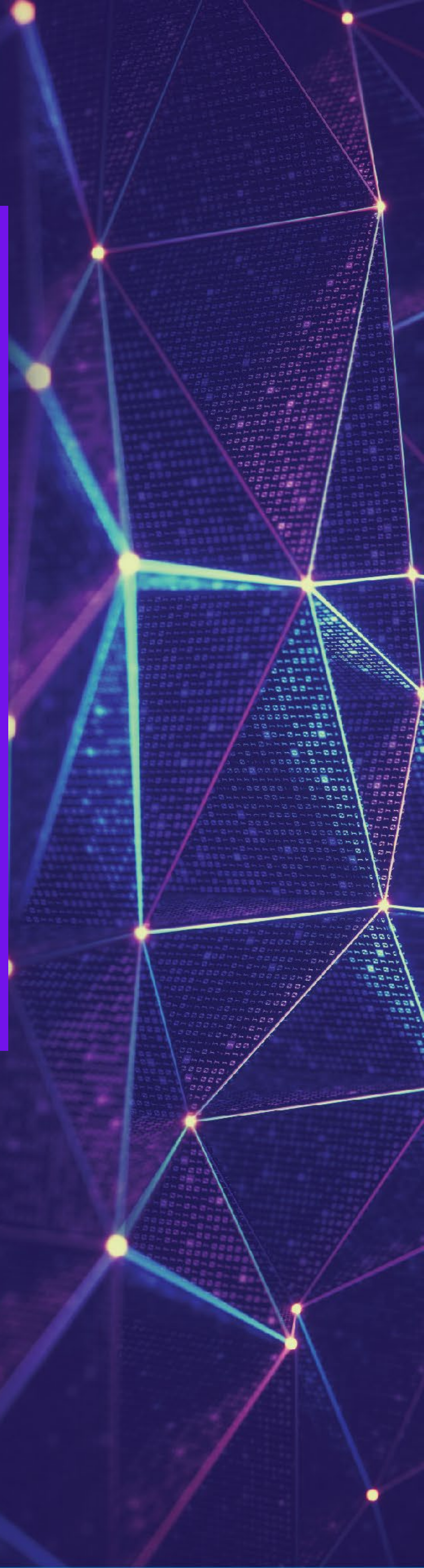
European Commission agenda for business taxation in the EU - one year later



August 2022

On May 18, 2021, the European Commission unveiled its Communication on "Business Taxation for the 21st Century" (the Communication). The document set out the Commission's views on the EU's tax policy agenda and plans for the implementation of the rules to be agreed upon at international level under the OECD's BEPS 2.0 project.

The Communication also outlined targeted solutions that went beyond the OECD agreement, in the form of five action points that were meant to support the EU's ambition for a holistic EU business tax framework that provides for 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[1].“

In this updated edition on the European Commission's Communication, we aim to take stock of developments that have taken place since the Communication was issued (May 2021) and August 2022.

Implementing the global agreement on BEPS 2.0 in the EU

The Communication provided an overview on how the global agreement at the level of OECD/G20 Inclusive Framework on BEPS (IF) would be implemented in the EU.

For consistency purposes and because not all EU Member States are OECD members or participate in the IF discussions (i.e. Cyprus), the Commission initially communicated that it would issue two directives to implement each of the two Pillars in the EU. However, in a subsequent FAQ on the Global Agreement on Corporate Taxation, the Commission noted that **Pillar One** would be mandatory for participating countries and would be implemented through an international multilateral convention; the Commission will therefore consider whether a directive for the implementation of Pillar One will in fact be needed. The Council of the EU is expected to hold a policy debate on the implementation of the global agreement on Pillar One at the Economic and Financial Affairs Council (ECOFIN) before the end of 2022.

Note: (1) Communication from the Commission to the European Parliament and the Council "Business Taxation for the 21st Century"

EU Digital levy

Under the Pillar One agreement, digital services taxes and other similar measures would be repealed. The EU digital levy initiative aims to generate a new source of revenue that will support the longer-term sustainability of the EU budget and enable investments in the digital transition. The Communication noted that the levy would be independent of the expected global agreement on the international corporate tax reform and would be designed in such a way that it is compatible with WTO and other international obligations. The Commission also noted that once se-tup, the digital levy would co-exist with the Pillar One agreement, as implemented in EU law. It was mentioned that this proposal would differ from the 2018 proposals for a Digital Services Tax and for a Significant Digital Presence, both of which would be withdrawn.

Initially scheduled for July 2021, the EU digital levy has been put on hold until the final details of Pilar One are completed and agreed upon. In The European Commission continues to monitor closely negotiations on the Pillar One multilateral instrument. The EC intends to submit a report on Pillar One to the ECOFIN Council by June 2023 and assess the situation accordingly with a view to submitting a related proposal, if needed.

The European Commission published the initial EU **Pillar Two** proposal – the Minimum Tax Directive, on December 22, 2021 after the OECD had published its Model Rules for the Global Anti-Base Erosion Rules (GloBE Rules) two days before.

Following technical discussions in the Council working groups, several amendments were introduced, with the aim of rectifying areas of discrepancy between the Model Rules and the initial text and to address concerns raised by Member States in respect of the short implementation timeline. Changes included an option for Member States to defer the application of the Income Inclusion Rule (IIR) and the undertaxed payments rule (UTPR) for up to six years where a maximum number of twelve Ultimate Parent Entities (UPEs) of in-scope multinationals are located in those Member States.

Member States were not able to reach political agreement on the compromise text under the French Presidency of the Council - see Euro Tax Flash Issue 478.

However, representatives of the Czech Republic (holding the Presidency for the second half of 2022) are optimistic about a possible agreement as early as October 2022. It remains to be seen whether any remaining concerns can be addressed before the year-end.

The Communication also sets out a number of action points in the area of corporate taxation that go beyond the OECD initiatives. These initiatives are discussed in more detail in the next pages.

Action 1

Legislative proposal for the publication of **effective tax rates** paid by large companies, based on the methodology under discussion in Pillar Two (potentially delayed in light of the stalled adoption of Minimum Tax Directive).

Action 2

Legislative proposal setting out rules to neutralize the misuse of EU shell entities for tax purposes (proposal was published on December 22, 2022), coupled with an upcoming proposal to address the use of non-EU shells.

Action 3

Recommendation on the domestic treatment of losses (published alongside the Communication).

Action 4

Legislative proposal creating a Debt Equity Bias Reduction Allowance (DEBRA) (proposal published on 11 May, 2022).

Action 5

Business in Europe: Framework for Income Taxation or BEFIT, moving towards a common tax rulebook and providing for fairer allocation of taxing rights between Member States (expected 2023).

The EU's new business tax agenda: ensuring sustainable growth and public revenues

18 May 2021

The world is changing Tax should too

A common rulebook for a better business environment in the Single Market

"Business in Europe: Framework for Income Taxation" (or BEFIT) will cut red tape, reduce compliance costs and minimise tax avoidance.

Ensuring greater public transparency

New proposal requiring certain large companies to publish their effective tax rates.

Supporting businesses to recover from COVID-19

Member States recommended to allow companies to offset their 2020 and 2021 losses against taxes they paid before 2020.

Tackling the abusive use of shell companies

New monitoring and reporting requirements for shell companies so tax authorities can better respond to aggressive tax planning.

Addressing the debt-equity bias in corporate taxation

Encouraging companies to seek finance through equity rather than debt.

On the road to 2050: Rethinking the EU tax mix

A comprehensive tax agenda, in line with global discussions, promoting fairness and supporting EU's green and digital transitions.

Source: European Commission website Communication on Business Taxation for the 21st Century (europa.eu)

Targeted short-term initiatives

The Communication acknowledges that achieving the Commission's long-term vision will take time, and that short-term initiatives are needed to address specific immediate challenges. The Commission therefore set out the EU's business tax agenda for the two years following the publication of the Communication, with a focus on two strategic areas:

1. Ensuring fair and effective taxation

Action 1

Proposal on disclosing effective tax rates paid by large companies

Increasing public transparency on taxes paid is viewed by the Commission as a first step for a fairer tax system. The initiative would require the annual publication of the effective corporate tax rate by certain large companies operating within the EU, based on the methodology agreed upon for the Pillar Two calculations.

A proposal was expected in **Q1 2022**, but the publication was delayed, potentially in light of the lack of progress on the adoption of the Minimum Tax Directive.

Action 2

Targeting the use of shell entities

Directive to neutralize the misuse of shell entities for tax purposes

The Communication also announced a proposal targeting the use of shell companies – initially defined as companies with no or limited economic substance. On December 22, 2021, the European Commission issued a proposal for a Directive aimed at **fighting the misuse of shell entities for tax purposes (also known as the Unshell Directive or ATAD 3).**

The intention is to disallow such entities the benefits of certain withholding tax reliefs, unless they are able to successfully challenge the presumption that they qualify as shells and benefit from tax advantages.

The Unshell Directive will impact all EU entities, irrespective of their legal form or size, unless they benefit from a carve-out. The text outlines a **seven-step process:**

- entities in scope need to self-assess against three criteria, referred to as 'gateways', that examine the type of income, volume of cross-border activity and level of outsourcing
- entities crossing all three gateways would be deemed to be at high-risk of lacking substance and would be required to report on their substance through their annual tax return
- reporting entities that fail to meet three cumulative substance indicators related to own infrastructure (premises and bank account) and nexus (employees and/ or directors), are deemed to be 'shell entities'
- the shell presumption can be rebutted by bringing evidence of commercial reasons and nexus
- entities can also request an upfront exemption by substantiating a lack of tax motives test
- tax consequences include denial of certain tax benefits
- data on shell entities would be automatically exchanged between Member States.

As mentioned above, 'shell entities', unless able to rebut this presumption, would be denied certain tax benefits otherwise available based on double tax treaties and the Parent-Subsidiary and Interest and Royalties Directives. In practice, this means that the Member State where the shell entity is resident would have to either deny the issuance of a tax residence certificate, or issue a certificate with a warning. The EU shareholder of the 'shell' would have to tax the payments received by the 'shell entity' as if received directly.

The Commission proposes that Member States should transpose the rules into domestic law by June 30, 2023 and that the provisions of the Directive should **apply as of January 1, 2024.** Note, however, that both the proposed timeline and the text of the Directive could suffer substantial changes during working group discussions in the Council. The Commission has also collected feedback on the initiative as part of a public consultation carried out at the beginning of 2022.

A progress report on the Unshell proposal is scheduled for deliberation in Council in December 2022.

Initiative aimed at tackling non-EU shell entities

On July 6, 2022, the Commission launched a public consultation on an initiative framed as a follow up to the Unshell proposal – a Directive to tackle the role of enablers that facilitate tax evasion and aggressive tax planning in the EU (Securing the Activity Framework of Enablers – SAFE). According to the related Inception Impact Assessment, SAFE is aimed at tackling the role of enablers in setting up complex structures in non-EU countries with the objective of eroding the tax base of Member States through tax evasion and aggressive tax planning. The policy options under considerations include:

OPTION 1

Prohibition on enablers from assisting in the creation of arrangements abroad that facilitate tax evasion or aggressive tax planning (to be defined), coupled with a requirement to carry out dedicated due diligence procedures, including a test to check whether the arrangement or scheme leads to tax evasion or aggressive tax planning.

OPTION 2

Prohibition to facilitate tax evasion and aggressive tax planning combined with due diligence procedures and a requirement for enablers to register in the EU.

OPTION 3

Code of conduct for all enablers
The public consultation period on SAFE ends on October 12, 2022 and the Commission is scheduled to put forward a proposal in the first quarter of 2023.

2. Enabling productive investment and entrepreneurship

Action 3

Recommendation on the domestic treatment of losses

Alongside the Communication, the Commission adopted a Recommendation on the domestic treatment of losses. In its Communication, the Commission acknowledged the steps taken by Member States in the current complex COVID-19 environment to support small and medium enterprises (SME) (e.g., deferral of tax obligations) but notes that SMEs are less likely to be able to absorb or finance losses due to reduced cash flow.

The Recommendation was aimed to assist companies, and SMEs in particular, to deal with the economic impact of COVID-19. Based on the Q&A published by the Commission in relation to the Communication, the Member States are recommended to allow for the carry-back of losses, to at least the previous tax year. As such, companies impacted by COVID-19 would be allowed to offset their 2020 and 2021 losses against taxed paid before the 2020 (a maximum limit of EUR 3 million per loss-making fiscal year is suggested).

The Commission undertook to also explore the possibility of a coordinated treatment of cross-border loss relief. Nothing further has been published in this respect.

Action 4

Proposal on creating a Debt Equity Bias Reduction Allowance (DEBRA)

The Communication noted a pro-debt bias under the current tax framework, which allows for the corporate income tax deductibility of interest expenses related to debt financing but doesn't provide for an equivalent deduction of costs related to equity financing. The EC expressed its intention to address this issue through the introduction of a debt-equity bias reduction allowance (DEBRA).

On May 11, 2022, the European Commission issued its proposal for a Directive on a DEBRA and on limiting the deductibility of interest for corporate income tax purposes. Subject to certain conditions, the proposal would:

- provide for a deduction from the tax base of a taxpayer in respect of the increases in its net equity in a given tax year. The allowance would be determined by multiplying the allowance base with a notional interest rate . The notional interest rate would be calculated based on the 10-year risk-free interest rate for the relevant currency, increased by a risk premium of 1 percent or, in the case of SMEs, a risk premium of 1.5 percent. The allowance would be deductible for ten years, however the deduction would be limited to a maximum of 30 percent of the taxpayer's EBITDA for each tax year.

- introduce a new limitation on interest deductibility, i.e. only 85 percent of exceeding borrowing costs (i.e. interest paid minus interest received) would be deductible. The limitation would need to be applied in conjunction with the interest limitation rules under the EU Anti-Tax Avoidance Directive.

The Directive further provides for specific anti-abuse measures to ensure that arrangements are not put in place to artificially benefit from the proposed new allowance on equity. A recapture rule provides that any subsequent decrease in equity would generate a taxable amount over 10 consecutive tax years, unless the taxpayer is able to demonstrate that the decrease exclusively relates to losses incurred during the tax year or to a legal obligation.

The Commission proposes that Member States should transpose the rules into domestic law by December 31, 2023 and that the provisions of the DEBRA Directive should apply as of January 1, 2024. Member States that currently apply a tax allowance on equity funding under national law would be allowed to defer the application of the Directive for a period of up to 10 years. As is the case for the Unshell initiative, the proposed timeline and the text of the DEBRA Directive could suffer substantial changes during working group discussions in the Council. Input from stakeholders was collected through a public consultation that rand through the end of July 2022.

A progress report on this initiative proposal is also scheduled for deliberation in Council in December 2022.

[1]The Explanatory Memorandum accompanying the draft Directive lists: Belgium, Cyprus, Italy, Malta, Poland and Portugal

Long-term initiatives

The Communication notes that the lack of a common corporate tax system within the EU represents a competitive disadvantage for the EU Single Market compared to third country markets. According to the EC, the current corporate tax framework acts as a distortive element for investment and financing decisions and increases compliance costs for multinationals.

To address this issue and building on the work undertaken at the level of the IF, the Commission set out an ambitious plan for a new framework for income taxation for businesses in Europe (Business in Europe: Framework for Income Taxation or BEFIT), to be proposed in 2023.

Action 5

Business in Europe: Framework for Income Taxation (BEFIT)

BEFIT will provide for common rules for determining the corporate tax base and for the allocation of profits between Member States, based on a pre-defined formula (formulary apportionment). It is envisaged that the proposal will build on the principles agreed upon under Pillar One and Pillar Two and will further adapt these to ensure suitability for extended use within the EU Single Market.

In short, BEFIT would consolidate the profits of the EU members of multinationals into a single tax base, to be subsequently allocated to Member States using a formula that will replace the current transfer pricing rules. The formula will be developed by considering issues such as: giving appropriate weight to sales by destination, reflecting the importance of the market where a multinational group does business, assets (including intangibles) and labor (personnel and salaries). Once allocated, profits would be subject to the corporate income tax rate of the respective Member State.

The pending Common Consolidated Corporate Tax Base (CCCTB) proposal will be withdrawn in light of this new initiative. Once implemented, BEFIT could represent a stepping-stone for the introduction of an even more ambitious initiative, i.e., the possibility of a single EU corporate tax return for a group.

NEXT STEPS

In addition to the timelines mentioned above for the various action points and commitments made, the European Commission has also launched a broader reflection on the modernization of tax systems and updates to the tax mix (labor taxes, including social contributions, currently provide more than 50 percent of the overall tax revenue in the EU 27) to better reflect ongoing and future economic and social developments. The EC has launched series of events to help steer the discussion towards a tax framework that is fit for the future, the culmination of which is a high-level Tax Symposium on November 28, 2022 on the “On the road to 2050: A tax mix for the future”.

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