European Union re-launches formulary apportionment: key points about the CCCTB

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The European Commission has recently released a Communication to the EU Parliament calling for a re-launch of its proposal from 2011 relating to the Common Consolidated Corporate Tax Base. The CCCTB essentially aggregates related EU companies into a single, consolidated tax return for all those entities. The EU group net taxable income is then apportioned back out to each entity and country in proportion to the relative assets and other economic factors within those locations. Thus, the CCCTB is a system of formulary apportionment which abandons the existing arm’s length standard of treating each inter-company transaction separately. Intercompany transactions are effectively eliminated in consolidation.

Although in 2011 the Commission saw the key benefits of the CCCTB in terms of reducing administrative burden for taxpayers and taxing authorities alike, it now sees the CCCTB as a holistic solution to combat multinational tax planning strategies that erode the taxable bases of EU countries. The Commission plans on presenting a detailed legislative proposal in 2016.

US multinationals with operations in the EU could be dramatically impacted – either for good or bad – by the imposition of the CCCTB regime. Originally proposed as an optional system at the election of a taxpayer, the CCCTB is now viewed by the Commission as a mandatory framework. "The EU’s CCCTB would sweep into a single tax filing all EU companies, even if the companies are owned, directly or indirectly, by a US parent."

CCCTB acknowledged as “ambitious”

The CCCTB is very similar to the long-established formulary apportionment regime used in the US by the various states which impose income taxes. Originally, most of such states used a simple three-factor formula (location of sales, tangible property, wages) to apportion the affiliated group’s taxable income, which started with the aggregate US federal taxable income of the entities involved. However, over time, the US states moved away from a common three-factor formula, with many states now employing a single factor (typically, sales) or multiple factors which can be either single- or double-weighted. Thus, there is now no uniformity to the US states’ formulary apportionment, and many complicated issues of combination also exist.

While US taxpayers might argue that the US state formulary apportionment system is complex and burdensome, it must be acknowledged that such a system can be implemented.

The CCCTB would be a uniform apportionment system throughout the EU. The original proposal in 2011 called for
the same three-factor formula originally used by the US states. Whether the 2016 legislative proposal retains that approach remains to be seen.

A daunting task for the CCCTB, however, is that it must first define a common definition of “taxable income.” Unlike in the US states, there is no existing EU federal definition of taxable income to leverage, so it seems the EU would need to essentially create the detailed equivalent of the US Internal Revenue Code. For example, the EU taxable income definition would need to define depreciation rates, time for inclusion of income, how research and development expenses are treated, whether capital gains exist and numerous other items.

The Communication, dated 17 June 2015, notes, “The CCCTB is a very ambitious initiative.” Accordingly, the Commission proposes to take the project in stages, with the first stage focused on defining the common tax base. It appears that the common base may be introduced in 2016, while the actual consolidation and allocation mechanism will be introduced in later years.

The Communication identifies five key areas for action, of which the CCCTB is but one. Others include work on the definition of permanent establishment, and the introduction of controlled foreign corporation tax rules. Interestingly, the Communication states that even before the full CCCTB consolidation regime is introduced, group entities would be allowed to offset profits and losses they make in different EU states. Perhaps as an enticement, this “single market” approach would certainly encourage those multinationals which cannot currently match profits in one EU affiliate with losses in the other to look favorably upon the CCCTB.

Approval process for the CCCTB

Even acknowledging that the CCCTB’s departure from the arm’s length standard – which is still endorsed by the OECD, even with all its BEPS initiatives – is a radical move, perhaps the biggest hurdle to implementing it is that there needs to be unanimous agreement by all EU members to its adoption. By its nature, the CCCTB can undermine the incentive nature of a country’s relatively lower tax rates under a separate country format, since such profits would then be aggregated and potentially allocated to other group companies with higher operational factors (such as sales), and potentially higher tax rates.

No wonder, then, that the UK financial secretary to the Treasury has already announced that his country will reject the CCCTB. In recent years, the UK has continually reduced its corporate income tax rate, which now stands at 20 percent, as a way to promote inward investment. And the UK has announced it plans to decrease the rate even further, down to 18 percent. Similarly, Ireland, with a corporate rate of 12.5 percent, has also recently stated that it objects to the CCCTB as unworkable and not feasible.

Undaunted, the Commission makes note that the CCCTB is an effective tool to ensure that group profits are allocated and taxed to the place where profits are generated. It remains to be seen whether the multi-year phased approach will allow for a reshaping of the CCCTB to allow both some tax rate competition while eliminating what is seen as artificial shifting of profits.

What about the Innovation Boxes?

One recent development which seems to be missing in the discussion of the CCCTB relates to the now quite common tax regime within the EU relating to Innovation (or Patent) Boxes. These regimes – adopted by such countries as the UK, Netherlands, Belgium and others – apply a lower statutory tax rate to certain types of income which result from the exploitation of developed intangible assets. Recently, the EU has come to an agreement that there should be an in-country nexus between the favored income and the actual development activity.

As originally proposed, the CCCTB allocation formula used as one of its factors the amount of tangible property in-country. Clearly, unless the CCCTB formula is modified for Innovation Boxes, the result would be that in-country income attributable to intangible assets would be allocated to group members with tangible assets, which could have much higher tax, non-preferential rates. The CCCTB could thus nullify the incentive nature of EU Innovation Boxes.

Conversely, since the CCCTB only applies to EU country entities, the proposed regime might be a compelling incentive to locate research and development activities in any non-EU country which has an Innovation Box. In such a structure, the EU country entities would presumably only accrue “routine returns” for their functions; there
would be no EU profits attributable to intangible assets to aggregate and apportion. Notably, Switzerland (not a member of the EU), has stated it is considering adding an Innovation Box tax regime.

Administrative burden

The Commission sees the CCCTB as a major step towards a better tax environment for business. Indeed, the ability to net profits in one affiliate with losses in another is a large benefit for business. And, it might also be the case that the administration of the CCCTB – once all the rules are established – would be simpler and more clear than the current system of analyzing all intercompany transactions under the arm’s length standard, which can be a bit subjective and burdensome. Arguably, if many countries adopt the recommendations of the OECD BEPS initiatives, there will be a significant increase in the amount of double taxation assertions by tax authorities. Such transfer pricing and permanent establishment cases can be extremely expensive, time consuming, intrusive and burdensome for multinationals to defend and resolve, even with mutual agreement procedures available.

So, it might be that the multinational taxpayers could ultimately endorse the concept of the CCCTB, if they were assured that favorable low tax rates and concepts such as EU Innovation Boxes could be accommodated.

Conclusion

Soon after its formal introduction in 2011, the CCCTB seemed to have been forgotten and relegated to the file drawer for hopeless causes. However, it has risen again, this time as a way for the EU Commission to draw upon the energy of the OECD BEPS initiatives to combat what it believes is abusive tax planning by multinationals. Indeed, the CCCTB would eliminate many tax planning strategies of EU taxpayers. However, the CCCTB faces stiff opposition even within the EU, and many of the consequences of its adoption could be harmful to EU member states.

Multinationals were wary of the CCCTB proposals in 2011, even when their adoption was optional, not mandatory. Those taxpayers who wondered whether the optional regime would ultimately turn mandatory need wait no longer for their answer.

Despite some potential reduction in administrative burden for both taxpayers and tax authorities, it seems likely the CCCTB may not generate sufficient consensus to be adopted. Nonetheless, even US taxpayers should review these developments with their management now, and consider providing their views to relevant trade groups, EU country administrations and other parties.

Find out more about the current Discussion Draft and its meaning for your tax planning by contacting the author.

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