New attempt to harmonise corporate taxation in the EU

European Commission public consultation on “Business in Europe: Framework for income taxation (BEFIT)”

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JEL-Classification

F23 – Multinational enterprises, international business activities
H25 – Corporate taxes and subsidies
H87 – International tax issues, international public goods

Abstract

In the course of 2023, the European Commission plans to present a proposal for a new corporate tax system under the title "Business in Europe: Framework for Income Taxation (BEFIT)". Essentially, BEFIT is about establishing common rules within the European Union (EU) for calculating, consolidating and distributing the tax base of companies. The current transfer pricing system based on the arm's length principle is to be partially abandoned in favour of a profit split based on an allocation key to be defined. The profit shares would continue to be subject to the respective national tax rates. The proposal is to be in line with the international tax reform concept of the OECD.

Regarding the political options for shaping BEFIT, the mandatory scope of application should be limited to very large corporations. For other companies, however, there should be an option to apply the BEFIT rules. When defining the allocation key for the distribution of consolidated profits among the member states, the European Commission should take into account the factors sales, labour and tangible assets. In view of digitalisation, the consideration of intangible assets seems obvious, but could lead to new distortions due to valuation problems and tax planning by companies.

The idea of a common consolidated corporate tax base in line with the OECD's tax reform concept is a promising approach, as it can reduce the red tape burden for multinational companies and tax authorities in the medium term and increase transparency. Overall, the initiative for a harmonised tax base for companies in the EU and a formula-based apportionment of profits between EU countries, in combination with the minimum tax rate initiated by the OECD, represents an opportunity to ensure fairness in tax competition within the EU and thus promote investment and economic growth.

However, the European Commission should bear in mind that such a fundamental change in the tax system would probably lead to noticeable revenue effects for the member states. Small countries, in particular, are likely to receive less tax revenue under a formula-based profit-sharing system than before.

1 Background to the initiative

In May 2021, the European Commission announced that it would develop a concept for "corporate taxation in the 21st century". A proposal for a new corporate tax system is to be published in the course of 2023. The title is Business in Europe: Framework for Income Taxation (BEFIT). In this context, the European Commission has conducted a public consultation (European Commission, 2023).

The background to this initiative is that there is currently no common corporate tax system in the European Union (EU). Instead, the 27 member states have sovereignty over the structure of the system. The European Commission expects harmonisation to strengthen the EU's competitiveness and reduce distortions in investment and financing decisions (especially when these are made based on tax planning strategies). In addition, compliance costs for companies are to be reduced at the same time.

A prerequisite for the European Commission is that the proposal is consistent with the principles of the inter-national tax reform approach of the Organisation for Economic Co-operation and Development (OECD) and the G20, the group of the 20 largest industrialised countries. The key objectives of BEFIT are to promote fair and sustainable growth and to ensure effective taxation. Simplicity and transparency are central to this. With BEFIT, the European Commission is not entering completely new ground. Rather, past initiatives serve as a template. To what extent BEFIT will differ from the previous concept of the Common Consolidated Corporate Tax Base (CCCTB), for example, remains to be seen until the Commission presents its proposal.

2 Political Context

The harmonisation of corporate taxation in the EU has been on the political agenda for many years. So far, despite several attempts, it has not been possible to design a common corporate tax base. As a result, there is still a lack of fair tax competition in the EU, as each member state can autonomously set tax incentives for the establishment or relocation of production facilities and intangible assets. Although the respective tax rate has an anchor function and symbolic power, the rules for determining the tax base are decisive for the effective tax burden.

In 2011, the European Commission made a first attempt to harmonise the tax base in the EU. However, the initiative failed due to a lack of support from the member states. The second attempt in 2016 to create a CCCTB also failed to reach a conclusion, although in the run-up Germany and France, as the largest member states, had strongly supported the revival of the initiative. In this context, the principle of unanimity in the EU on tax issues makes reforms difficult (Beznoska/Hentze, 2019).

In addition, there is an initiative by the OECD to agree on common standards in international corporate taxation at the supranational level. In 2013, the OECD presented a first draft of its action plan against Base Erosion and Profit-Shifting (BEPS), followed by a final report in 2015. Since then, the BEPS project has been intensively pursued. Currently, the OECD (together with the G20 countries) is developing an international tax reform concept, the so-called Inclusive Framework, to standardise international tax rules and as a multilateral instrument to combat tax avoidance (OECD, 2022). At present, 137 countries have signed up to this concept. The Inclusive Framework is based on two pillars. While the first pillar provides for a formula-based profit allocation for the fair distribution of taxing rights, the second pillar is primarily concerned with a global effective minimum tax. BEFIT is to take up elements of the CCCTB initiative and also build on the

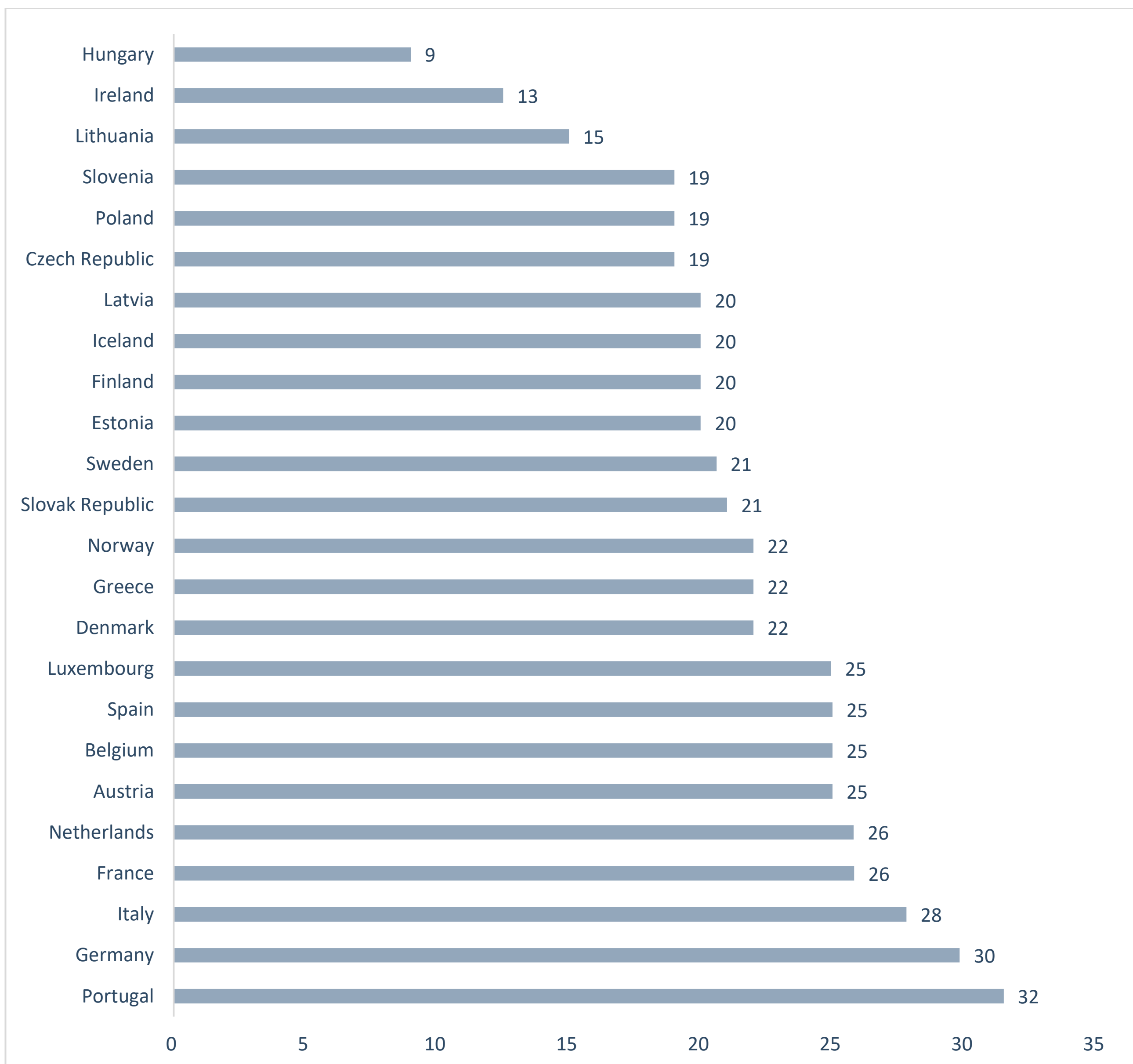
OECD's two-pillar concept. This time, the European Commission hopes for more political support from the member countries than in previous attempts.

3 Subject matter and objectives

With its proposal on corporate taxation in the 21st century, the European Commission is sticking to its ambitious plans to unify the corporate tax base in the EU. In essence, the current transfer pricing system based on the arm's length principle is to be partially abandoned in favour of an allocation of profits based on a formula to be defined. The profit shares would continue to be subject to the respective national tax rates.

Figure 3-1: Statutory corporate tax rate 2022

Statutory corporate income tax including local surcharges in per cent



Source: OECD, 2023

An important motivation for this project is that existing tax rules do not adequately cover digital business models with extensive intangible assets and thus cannot ensure fair and transparent taxation. A unified system could reduce distorted investment and financing decisions by companies through tax incentives and thus increase the competitiveness of the single market. At the same time, bureaucratic costs for both companies and tax administrations should be reduced in order to increase efficiency by establishing a uniform, transparent and easily understandable framework. Overall, the aim is to establish common rules for calculating, consolidating, and allocating the tax base of a multinational enterprise (MNE). However, it also ensures that tax competition via the statutory corporate tax rate remains possible. The basic idea of allowing a certain degree of competition via the corporate tax rate does not contradict the idea of a free internal market. The differences between countries with regard to their statutory corporate tax rates are considerable in some cases (Figure 3-1). Germany is one of the high-tax countries (Hentze/Kolev, 2021). In some countries, however, statutory and effective tax rates diverge significantly, as certain reductions in the tax base are granted (Janski, 2019). For Germany, however, it should be noted that the difference between the statutory and effective tax rates is imperceptible (Hentze, 2019a).

4 Policy options

According to the European Commission, the essential elements of an appropriately designed tax base should be specified to the member states by directive in order to ensure a high degree of effectiveness, in contrast to non-binding recommendations. Hereby, the European Commission particularly focuses on the following criteria, for which a design is required.

4.1 Scope

The proposed threshold value for the consolidated annual turnover of a group of companies of 750 million euros means that small and medium-sized enterprises (SMEs) as well as many larger companies would not be covered by the regulation. Only a small proportion of companies would be covered by the threshold. Around 0.7 per cent of companies in Germany were classified as large companies in 2020 according to the European Commission's definition – that is around 23,000 companies (IfM, 2023a). However, the category already includes companies with sales of more than 50 million euros, provided they also have at least 250 employees (IfM, 2023b). In Germany, just 827 companies exceed the revenue threshold of 750 million euros at the current margin (Greive/Hildebrand, 2021).

Since the goals of BEFIT are to reduce compliance costs and establish a level playing field, the regulations should optionally be open to a larger group of companies. This would make it possible to accommodate particularly ambitious SMEs. In case of doubt, this option would prevent an undesired application of BEFIT.

A central concern of the European Commission in designing BEFIT is to find regulations in line with the OECD's tax reform concept. Thus, for the scope of BEFIT, an alignment with the threshold in Pillar 2 of the Inclusive Framework would make sense in principle, which is multinational companies with an annual turnover of 750 million euros or more (OECD, 2021a). The rationale for this threshold is to ensure consistency with existing international corporate tax guidelines, such as the country-by-country reporting (CbCR) rules (OECD, 2021b). From an economic point of view, it could also be justified, for example, to base the definition on the distinction between SMEs and large companies. Ultimately, the definition of any threshold is a matter of political discretion.

As the BEFIT regulation is based on the EU proposal for a Pillar 2 directive, there would be a deviation from the general OECD's model rules in that the EU directive extends application to purely domestic groups of companies in order to ensure compatibility with fundamental freedoms (European Commission, 2021).

Sectoral exemptions from the BEFIT regulations should be avoided where possible. Adjustments for the financial services sector could be useful. For example, this sector is excluded from Pillar 1 of the Inclusive Framework, because there are differences between financial reporting and the reporting standards of other sectors, and because it is argued that financial service providers must operate in the place where they earn their income (OECD, 2021b). Accordingly, it would make sense to adapt the BEFIT formula for profit sharing in this case. At the same time, however, it should be noted that applying Pillar 1 to the financial services sector could significantly increase tax revenues due to its high profitability (Devereux/Simmler, 2021). An entire exclusion of a sector or deviating provisions for a sector from the BEFIT regime should in any case be well weighed and justified.

4.2 Calculation of the tax base

While a comprehensive set of tax rules may entail higher compliance costs and is rather detrimental to a simple, transparent system, limited harmonisation also has relevant weaknesses. Without a far-reaching harmonisation of accounting rules to determine the tax base, Pillar 2 of the Inclusive Framework is also insufficient (Spengel et al., 2023).

An example of the problem of non-comprehensive regulation is the treatment of company pension provisions. From a tax perspective, the EU member states handle corporate pension provisions for direct commitments differently. While there are no special rules in most countries, tax law in Austria, Germany, Italy, Luxembourg, the Netherlands and Sweden requires provisions for future pension payments. This is not only a technical issue, but has a relevant impact on the corporate tax base.

In 2011, the European Commission had still proposed closing the gap between national tax systems with regard to corporate pensions as part of the first CCCTB initiative. Article 26 of the European Commission's CCCTB Directive proposal of that year recommended the use of "reliable appropriate methods for estimating employees' entitlements and discounting future pension payments by reference to the Euribor rate for 12-month commitments" (European Commission, 2011, 28).

In contrast to the 2011 initiative, the 2016 proposal for a common measurement base was less strict. Article 24 of the CCCTB Directive states that "Member States may provide for the deduction of pension provisions" (European Commission, 2016a, 34). Article 44 added that pension provisions that are deductible under national law "shall be deducted from the attributable share" (European Commission, 2016b, 33). Consequently, the tax treatment of pension provisions should be regulated at national level. However, such an approach leads to the fact that a common tax base can only be achieved to a limited extent.

Another argument in favour of comprehensive regulation is the restriction of so-called patent or license boxes. To date, many countries, including EU countries, use this instrument to attract intangible assets from MNEs. A formula-based division of the tax base could reduce the incentive for such a construct and thus contribute to fair tax competition (Hentze, 2019b).

Against this background, the concept of a comprehensive set of tax rules taking into account all relevant aspects is adequate. The resulting compliance costs should be kept in mind and minimised as far as possible.

4.3 Formula for allocating taxable profits

Since BEFIT is supposed to be in line with the two-pillar concept of the OECD, a uniform regulation by the EU and the OECD makes sense. However, while the European Commission has so far relied on a three-part allocation key for profit sharing in the BEFIT formula (tangible assets, labour in the form of personnel and wages, sales), the OECD countries advocate a sole orientation to sales in the formula-based reallocation of taxation rights in Pillar 1. One could therefore assume that there is inconsistency between the two regulations. However, it should be noted that Pillar 1 only refers to 25 per cent of a company's residual profit (Amount A). This corresponds to the portion of total profit that exceeds a pre-tax return on sales of 10 per cent. The formula-based redistribution of taxing rights under Pillar 1 thus focuses on a type of "excess profit" and thus has only a relatively limited scope of application, which aims to allow market states, i.e., those states in which the actual sales are generated, to have a share of the resulting tax revenues.

The situation is different with the BEFIT regime, whose profit-sharing formula would apply to total profit and is intended to reflect the actual sources of income generation. Thus, the three-part allocation formula under consideration, based on tangible assets, labour and sales, seems to make more sense. A deviation from the OECD approach would not be critical.

The question of the extent to which intangible assets should be included in the formula-based distribution of profits arises above all in view of the large digital groups, which generally have extensive intangible assets. As a result, corporations such as Google and Amazon would have to pay more taxes in Europe. However, intangible assets are difficult to value and are also usually relatively mobile. Applying the formula to intangible assets within the EU could therefore only lead to intra-group relocations to other regions. When acquiring intangible assets from third parties, inclusion in the formula would be less critical because of the market price paid (Martins/Taborda, 2022). However, such complex differentiation would lead to additional compliance costs. Moreover, it would be unsystematic to include certain acquisitions of intangible assets (in the case of third parties) but exclude others (in the case of affiliated companies).

One idea put forward by the European Commission in response to the valuation problem is to take into account proxy values, such as expenses for research and development (R&D) or marketing. The argument against using proxy values is that these expenses are derived from employment (R&D employees) or tangible investments (e.g. laboratories) and are thus already captured by the other factors (De Mooji et al., 2021).

The inclusion of intangible assets is thus not without problems, especially since it is necessary to ensure the competitiveness of EU-based companies, also compared to companies outside the EU to which the new rules would not apply.

4.4 The allocation of profit to related entities outside the group

Simplified concepts to reduce compliance costs when allocating profits to related companies outside the consolidated group make sense in principle. Although relying on macroeconomic industry benchmarks for this purpose cannot replace an individual analysis, possible deviations are likely to be rather small in many cases. However, if the European Commission stipulates that in every case the regular transfer pricing analysis must also be carried out according to the arm's length principle, there is a risk that compliance costs will increase. However, the question then arises as to what extent companies and tax authorities would gain from such a step.

4.5 Administration

Against this background, the European Commission should keep a close eye on compliance costs for companies and public administration when developing the BEFIT concept. Reducing compliance costs for companies and audit costs for tax authorities is a fundamental goal of BEFIT, against which the proposal must be measured. Cost savings on both sides should be ensured at least within a time window of a few years. One-off start-up or changeover costs for companies and administrations probably cannot be avoided entirely.

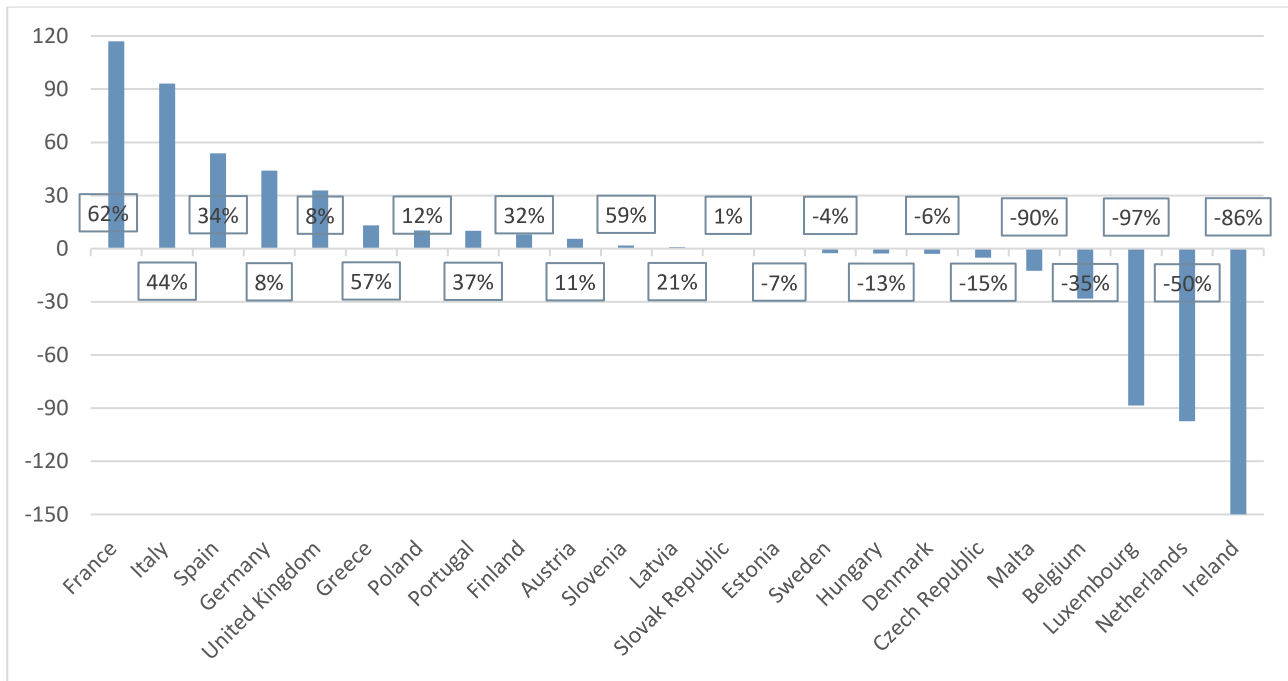
5 Impact assessment

The potential impact of BEFIT on member states' tax revenues should not be underestimated. In particular, small countries, such as Ireland, Luxembourg and Malta could lose considerable parts of their tax base as a result of formula-based profit sharing, while large sales markets, such as France, Italy, Spain and Germany, would tend to gain. This is shown by a statistical simulation of the effect of formulaic profit split according to the CCCTB proposal on the tax base of EU member states compared to the current transfer pricing system (Figure 5-1). Behavioral adjustments by companies and member countries could mitigate the impact.

From a systematic point of view, a common tax base would only be fully convincing if there were a global agreement. This would change the distribution effects even further. If instead of the EU states, the G20 states, i.e. the member states of the EU and the 19 most important industrialised and emerging countries of the world beyond them, were to introduce such a system, the EU states in particular – even the large ones – would lose part of their taxable profits. The beneficiaries would be the U.S., mainly due to the high consumption of its citizens, and China and India, due to the high number of employees. Consequently, whether a country is among the winners or losers of a common tax base in terms of tax revenues depends not least on which other countries participate (Hentze, 2019a).

Figure 5-1: Change in the tax base under a formula-based allocation of profits in the EU

Simulation for 2015 in billions of U.S. dollars and as a percentage of the previous tax base



Source: Hentze, 2019a

6 Conclusion

Ensuring fair tax competition and promoting investment and economic growth should be the main objectives in changing the corporate tax system. The idea of a common consolidated corporate tax base in line with the OECD's two-pillar approach is a promising approach, as it could reduce the red tape burden on MNE and tax authorities and increase transparency. However, there is a risk that BEFIT will initially increase compliance costs for companies. The European Commission should therefore responsibly balance tax accuracy against disproportionate compliance costs.

Tax competition can take place both at the level of the tax rate and at the level of the tax base. To ensure fair competition, both parameters must be taken into account. The OECD initiative for a global minimum tax in Pillar 2 makes an important contribution in this respect. According to the proposal, competition via the tax rate would not be excluded, but rather limited downward.

However, the OECD initiative has not yet been able to agree on a harmonised tax base. This could hamper its success. Therefore, the Commission's proposal to introduce a common set of rules for calculating the tax base for companies in the EU and to distribute profits among the EU states on a formula basis is the necessary second step to ensure fair tax competition at least within the EU. A uniform and consolidated tax base in combination with a minimum tax of 15 per cent would guarantee fair and transparent competition between member states regarding the tax rate.

Other elements of the EU proposal on corporate taxation in the 21st century could support BEFIT: An expansion of loss offsetting would be an appropriate change to the tax system (Hentze, 2020; Hentze/Hüther, 2022). Eliminating tax discrimination against equity-financed investments would also be systematically

appropriate (Debt-Equity Bias Reduction Allowance – DEBRA; European Commission, 2022). However, it should be borne in mind that restricting the deductibility of interest on debt capital would in fact increase the tax burden and thus jeopardise investment and economic growth. In order to strengthen investment, the tax deductibility of imputed equity costs should therefore be made possible in principle.

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