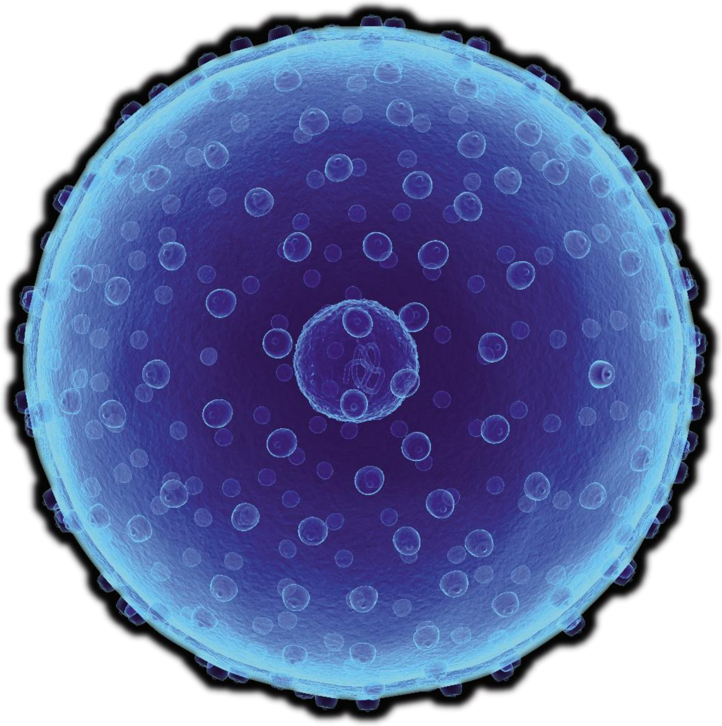

EU Developments: C(C)CTB and corporate tax reform

27 October 2016

Introduction

On 25 October, the European Commission published a corporate tax reform package that provides three new proposals:

- To provide for a Common Consolidated Corporate Tax Base (CCCTB) albeit in two stages
- To deal with hybrid mismatches between EU countries and non-EU countries and
- To provide new dispute resolution rules to relieve problems with double taxation for businesses.

The CCCTB proposal is made up of two elements being a Common Corporate Tax Base (CCTB) and a Common Consolidated Corporate Tax Base (CCCTB), both of which are discussed below. The CCTB is stage one of a two-stage approach towards an EU-wide corporate tax system and it lays down common corporate tax rules for computing the tax base of large companies and permanent establishments in the EU. The second stage seeks to bring about a fully consolidated corporate tax base, or CCCTB, across Member States. This initiative was previously launched in 2011 as a "big bang" optional approach, as opposed to a staged mandatory approach, which is now being suggested by the Commission; the 2011 approach effectively stalled. The European Commission's aims for this relaunch are to facilitate business within the EU by subjecting large taxpayers to a "single rulebook of corporate tax legislation" to apply across the internal market and to make the system more robust and "resilient to aggressive tax planning". Smaller corporate groups would have the option to participate in this regime. The Commission notes that both aims have a decisive and direct impact on the internal market and are aimed at eradicating perceived distortions in its functioning. That said, the costs of maintaining two tax systems (one mandatory and one optional) would have to be factored into this proposal.

Our perspectives in an Irish context

Ireland has always committed to playing fair, but playing to win, in matters of tax policy. In the "Update on Ireland's tax Strategy document" published by the Department of Finance as part of Budget 2017, the point is made that *"Ireland will engage fully in discussions on this proposal while assessing whether it is in our best interests. Taxation remains an area for unanimous decision making at Council, as laid out in the Treaties"*. This assessment is necessary because the most controversial aspect of the proposal (albeit the full concept itself could be regarded as controversial) is the consolidation element, which requires that the tax bases of companies within a corporate group are allocated among various Member States by a formula that includes, labour, assets and sales by destination as the distributive factors. As an exporting country, Ireland would be negatively affected by such formulary apportionment, given the latter requirement.

It is important to remember that the proposal does not affect a country's corporate tax rates, and therefore, Ireland's 12.5 per cent corporate tax regime is not affected by these proposals. Leaving aside the consolidation element, certain aspects of the proposal are already contained in Irish law, but where there are differences they are substantial (e.g. treatment of R&D expenditure and tax depreciation on certain assets). Such differences serve to decrease Ireland's competiveness vis-à-vis other Member States and the proposal as currently written attempts a one-size-fits-all approach that does not recognise the needs of a small, open economy like Ireland. Furthermore, given the widely differing economic circumstances of the current 28 EU Member States, and the fact that the right to set taxation policy accordingly resides with the Member States themselves under EU law, very careful scrutiny of the proposed directives and their expected impact is necessary by each Member State. It must be recalled that such proposals, like the previously agreed Anti-Tax Avoidance Directive (ATAD), require the unanimous agreement of Member States.

The provisions regarding hybrids bring about additional complexity in connection with establishing whether a mismatch exists in the first instance. The provision regarding the resolution of double taxation will be relevant to those companies engaged in such differences with foreign tax authorities.

Step 1: Common Corporate Tax Base (CCTB)

Scope of application and commencement

The directive will be mandatory for companies, other than certain shipping companies, which belong to groups beyond a certain size (in general, a consolidated group for financial accounting purposes with a total consolidated group revenue that exceeded €750 million in the financial year preceding the relevant financial year). This will ensure that if the full initiative comes about with the adoption of consolidation and the apportionment formula as part of stage two, then all taxpayers under the CCTB will automatically move into the CCCTB scheme. These common rules are optional for smaller groups of companies that do not comply with these conditions. Further, the proposed directive applies to a company that is established under the laws of a third country in respect of its permanent establishments situated in one or more EU Member States where the company meets the abovementioned conditions.

Like the Anti-Tax Avoidance Directive, this initiative requires unanimous agreement by each of the Member States before this can be brought about into law. If the proposal is agreed by the various countries then the laws, regulations and administrative provisions necessary to comply with this directive are to be adopted and published by 31 December 2018 “at the latest” and apply from 1 January 2019. It is important to note that a directive is binding, as to the result to be achieved, however, the national authorities are allowed the choice of form and methods for achieving this result. As such, the directive is written in general terms, since the detail is to be left to each of the Member States to decide on its form in domestic law.

Definition of a Permanent Establishment (PE)

The concept of a permanent establishment in this directive is defined similarly to the post-BEPS recommended definition of PE in the OECD Model Tax Convention. The definition deals with PEs situated within the EU and belonging to a taxpayer who is resident for tax purposes within the EU. The proposal explains that it was not seen as essential to put forward a common definition for PEs of taxpayers who are resident in a third country irrespective of whether the PEs are situation in the EU or otherwise. As such, the third-country dimension is thus left to be dealt with in bilateral tax treaties and national law.

Tax base

This is broadly defined and some key points are:

- All revenues will be taxable unless expressly exempted
- Proceeds from the disposal of shares held in a company outside the group will be exempt where the taxpayer has maintained a minimum holding of 10 per cent in the capital or voting rights of the company during the 12 months prior to the disposal, with the exceptions of shares held as trading stock and shares held by life assurance companies
- An exemption applies for dividends received with similar conditions applying
- Similarly, income of a PE received by the taxpayer in the Member State of residence is to be exempt. The purpose of such provisions is to avoid double taxation.

Taking the share disposal as an example, Ireland has a similar provision, albeit the holding requirement is five per cent, and it is necessary for the disposal to occur during a period of 12 months where the conditions are met such that it is not necessary to wait for 12 months before the disposal can be exempted for Capital Gains Tax purposes.

Taxable revenue is arrived at by deducting business expenses and certain other items from revenues with the basic test for deductible expenditure being that the expenses *"are incurred in the direct business interest of the taxpayer"*. This is added to with the directive noting that these expenses shall include costs of sale and all expenses, net of deductible VAT, which the taxpayer has incurred *"with a view to obtaining or securing income"*. Ireland has a "wholly and exclusively" requirement in ascertaining deductibility of expenditure when calculating trading income, but various other expenses are deductible depending on what type of income is under review (e.g. rental income, etc.) and therefore the question arises as to how such various income streams would continue to be calculated for tax purposes.

Under current Irish tax law, revenues are calculated depending on the nature of the income concerned. For example, for companies carrying on a trade then the starting point for such companies is the profit computed in accordance with their financial statements prepared under Irish Generally Accepted Accounting Practice (GAAP) or International Financial Reporting Standards (IFRS). For other revenues, such as rent, interest and capital gains, then the taxable amount can be calculated on an arising or receipts basis depending on the nature of the receipt involved. Under the CCTB, it would seem that the overall intent seems to be to follow the financial statements for same. This may mean that income that would not have become taxable until receipt may be taxable when accounted for and indeed may give rise to deferring taxation of income when it would have previously been taxed on a receipts basis. This would give rise to a substantial change to the Irish method of taxation.

To support innovation in the economy, the proposal introduces a "super-deduction" for R&D costs. R&D costs will be fully expensed in the year incurred (with the exception of immovable property). In addition, taxpayers will be entitled, for R&D expenditure of up to €20,000,000, to a yearly extra super-deduction of 50 per cent. For R&D expenditure in excess of that amount then, taxpayers may deduct 25 per cent of the exceeding amount. Further, the proposal outlines an enhanced super-deduction for start-up companies. Taxpayers who qualify as start-ups may deduct 100 per cent of their R&D costs insofar as these do not exceed €20,000,000 and provided that these taxpayers do not have any associated enterprises. All of the above must be compared with the R&D regime that currently exists within the Irish tax code, which allows for a deduction and a credit, refundable in certain instances, of 25 per cent of the qualifying R&D expenditure. Bringing about such a change may decrease Ireland's competiveness in this area and particularly so when one considers that the recent documents accompanying Budget 2017 refer to Ireland's R&D credit regime as being "best in class". Interestingly, the proposal for the second stage of this initiative, being the consolidation stage, notes that, *"R&D tax incentives are not only maintained but also enhanced and streamlined"*. If this means that the regime in the CCTB is the enhancement with a super deduction, then this must be questioned from an Irish tax perspective.

Interest limitation rule

This rule was contained in the ATAD, albeit with some modifications. It limits the deductibility of interest (and other financial) costs, in order to discourage practices of profit-shifting towards low-tax countries. The rule allows full deductibility of interest (and other financial) costs against taxable interest (and other financial) revenues. Any surplus of interest costs will be subject to deductibility restrictions, to be determined by reference to a taxpayer's taxable earnings before interest, tax, depreciation and amortisation (EBITDA). The ATAD allowed for such interest restriction to be deferred until 2024 at the latest for countries that have domestic rules that are equally as effective as those contained in the ATAD. The Department of Finance has said, *"The provisions on interest deductions are deferred until 2024 for countries, like Ireland, that already have strong targeted rules."*

Such commencement date must surely be reviewed in light of the already agreed ATAD and indeed may have to be agreed at an EU level in any event.

Allowance for Growth and Investment

The proposal aims to tackle the asymmetry whereby interest paid out on loans is deductible (subject to some limits) from a taxpayer's tax base while this is not the case for profit distributions: the so-called 'debt-equity bias'. Given the perceived risks that such a situation entails for the indebtedness of companies, the proposal seeks to neutralise the current framework that discourages equity financing. A taxpayer will be given an allowance for growth and investment according to which increases in its equity will be deductible from its taxable base, subject to certain conditions.

Tax depreciation

The proposal outlines the tax depreciation (or form of capital allowances) available in respect of certain asset types. For example, and with the exception of certain pooled assets, under the CCTB fixed assets can be depreciated individually over their useful lives on a straight-line basis, as follows:

Asset	CCTB rate	Current rate
Commercial, office and other buildings, as well as any other type of immovable property in use for the business, with the exception of industrial buildings and structures	40 years	Generally 25 years
Industrial buildings and structures	25 years	Generally 25 years
Long-life fixed tangible assets, other than the assets referred to above	15 years	8 years
Medium-life fixed tangible assets	8 years	8 years
Fixed intangible assets, the period for which the asset enjoys legal protection or for which the right has been granted or, where that period cannot be determined	15 years	Generally, allows depreciation in financial statements to be adhered to for tax purposes.

It can be seen from the above that Irish taxpayers would in general see tax depreciation reduce as a result of a move to the CCTB and consequently, depending on their individual fact pattern, see their tax charges increase as a result.

Losses

Taxpayers are allowed to carry losses forward indefinitely without restrictions on the deductible amount per year both under current law and this proposal. The directive draws a link between the interest limitation rules and the tax treatment of losses. A policy choice was thus made to draft an "effective interest limitation" rule, to the effect that any amounts qualifying as a loss reflect the outcome of trading activity. The rule has also been reinforced with an anti-abuse provision to discourage attempts to circumvent the rules on loss deductibility through purchasing loss-making companies. The proposal notes that, *"Regarding the prospect for a loss carry-back, no such a rule would need to be introduced because that this is relatively rare in the practice of Member States, and tends to lead to excessive complexity"*; Ireland has such a rule and it would appear questionable if such a rule would be available in a post-CCTB environment. This 'throwback rule' allows companies a cashflow advantage where they are trading at a loss and this provision would seek to remove that advantage; Ireland already has significant anti-avoidance provisions in connection with loss-buying and so on such that the proposal seems particularly onerous given the circumstances of losses arising.

Temporary loss relief with recapture

The directive notes that a form of group relief is available, "In order to partially make up for the absence of the benefits of cross-border consolidation during the 'first step', there will be a possibility to consider, under strict conditions, losses incurred by an immediate subsidiary or permanent establishment situated in other Member States". This relief will be temporary since the parent company will add back to its tax base, considering the amount of losses previously deducted, any subsequent profits made by its immediate subsidiaries or permanent establishments. Furthermore, if the incorporation does not occur within a certain number of years, the deducted losses will anyway be reincorporated automatically. This is a significant restriction on group loss-relief in that under Irish law such group losses (with the exception of capital losses) can be transferred intragroup up and down the corporate chain, provided the necessary shareholding conditions are met.

Anti-tax avoidance

The General Anti-Abuse Rule (GAAR) is drafted similarly to the text featuring in the ATAD and is supplemented by measures designed to curb specific types of tax avoidance. The proposal notes that in order to prevent discriminatory situations, it will be critical to ensure in practice that the GAAR applies to domestic situations, within the European Union and vis-à-vis third countries in a uniform manner, so that their scope and results of application in domestic and cross-border situations do not differ. The wording in the ATAD differs from that of the CCTB in that the former requires the avoidance transaction be ignored and taxed accordingly, whereas the latter requires the transaction be treated for tax purposes in accordance with its economic substance. This may produce similar results in some situations, but not necessarily all, and it is questionable as to why such a change was made to an already agreed directive.

Furthermore, Ireland has had a GAAR since 1989 (the former s.811 TCA 1997) and our Irish GAAR provisions were completely overhauled by Finance Act 2014 with the introduction of a new s.811C TCA 1997. The new provisions now have a lower threshold applied in assessing whether a tax avoidance transaction is at issue – the test now being focused on whether, broadly, it would be "reasonable to consider" that a transaction's primary purpose was to give rise to a tax advantage. In our view, the current Irish GAAR provisions are in fact more stringent and broader in scope and application than that proposed under the draft directive.

Where specific anti-tax avoidance measures are concerned, the proposals include a **switch-over clause,** which is targeted against certain types of income originating in a third country. This was not included as part of the ATAD as agreed among Member States. It aims to ensure that income is taxable in the EU if it was taxed below a certain level in the third country. The provisions of the switch-over rule in the ATAD (as initiated) outlined that where profits of a third country are taxed at a corporation tax rate lower than 40 per cent of the rate in the Member State of the taxpayer, such profits or proceeds from a share disposal held in a third country should not be exempt from tax. The provision contained in the draft CCTB directive notes that a rate of lower than 50 per cent of the rate in the Member State of the taxpayer is to be considered for this rule to apply. In addition, the ATAD contained an exclusion within the switch-over provisions for losses incurred by the PE of a taxpayer situated in a third country and losses on the disposal of shares in an entity resident in a third country, but the CCTB only contains an exclusion for the latter.

Controlled foreign company (CFC) legislation is similar to that contained in the ATAD, which has the effect of re-attributing the income of a low-taxed controlled subsidiary to its parent company in an effort to discourage profit-shifting. CFC rules extend to the profits of permanent establishments where those profits are not subject to tax or are tax exempt in the Member State of the taxpayer. However, the CFC rules in the ATAD allowed Member States to exclude certain entities that had accounting profits of no more than €750,000 and non-trading income of no more than €75,000, or of which the accounting profits amount to no more than 10 per cent of its operating costs for the tax period, and this is not reflected in the CCTB. It was seen earlier that a participation exemption will apply for certain foreign dividends and should CFC provisions be brought into Irish law, as required in accordance with the ATAD, then a participation exemption for dividends should equally apply.

Exit taxation rules similar to those contained in the ATAD have been included in the CCTB. The ATAD allowed a payment of the exit tax on an instalment basis, which is not present in the proposed tax base. It is assumed that the proposal will be updated to take account of such initiatives.

Hybrid mismatches: Given that mismatches emanate from national differences in the legal qualification of certain types of entities or financial payments, they should normally not occur amongst companies that apply the common rules of the CCTB for calculating their tax base. Since, however, mismatches are likely to persist in the interaction between the CCTB and national or third-country corporate tax systems, this directive lays down rules whereby one of the two jurisdictions in a mismatch would deny the deduction of a payment or ensure that the corresponding income is included in the corporate tax base. These rules go beyond those contained in the ATAD.

Step 2: Common Consolidated Corporate Tax Base (CCCTB)

This proposal is the ‘second step’ in a two-step, staged approach towards an EU-wide corporate tax system with cross-border consolidation of the tax results amongst members of the same group.

Definition of group

This has a two-part test based on: (i) control (more than 50 per cent of voting rights); and (ii) ownership (more than 75 per cent of equity) or rights to profits (more than 75 per cent of rights giving entitlement to profit). The thresholds have to be met throughout the tax year or the company will have to leave the group immediately. There is also a minimum requirement of nine consecutive months for establishing group membership.

Formulary apportionment

This is the most controversial aspect of the CCCTB and remains unchanged since this was last proposed in 2011. According to the Commission’s proposal, the CCCTB would make it possible for groups of companies to consolidate all profits and losses across the EU. The single consolidated tax return would be used to report the consolidated base of the group, after which all Member States in which a group company is active would be entitled to tax a certain portion of that base. This work would all be done through the tax authorities of the group’s principal Member State and involves allocating the tax bases of the group to the various Member States in order to determine the group’s tax liability. This is done by applying a formula to the tax base of the group and that formula comprises three equally weighted factors (i.e. labour, assets and sales by destination). The Commission notes that, *“this combination reflects a balanced approach to distributing taxable profits amongst eligible Member States”*. The “labour factor” is divided into payroll and the number of employees in order to account for differences in the levels of wages across the EU and thereby, according to the Commission, allow for a fairer distribution. The “asset factor” consists of all fixed tangible assets. Intangibles and financial assets will be excluded from the formula *“due to their mobile nature and the risks of circumventing the system”*. The Commission is of the view that these factors and weightings should ensure that profits are taxed where they are actually earned.

The sales-by-destination factor is critical for a country, like Ireland, which exports significantly. In that instance, the sales element of the formula notes that, among other conditions, sales of goods shall be included in the sales factor of the group member located in the Member State where the dispatch or transport of the goods to the person acquiring them ends. Where that place cannot be determined, the sales of goods shall be attributed to the group member located in the Member State of the last identifiable location of the goods. Supplies of services shall be included in the sales factor of the group member located in the Member State where the services are physically carried out or actually supplied. For a country with significant exports, like Ireland, one can clearly see the negative impact of allocating part of a tax base to the country of receipt of the goods and services rather than the country of origination.

Indeed, the Irish Exporters Association noted as part of its 2015 annual report that, *“Despite being a strong, open economy, Irish exports remain heavily dependent on three main export markets. In 2015, the EU, excluding the UK, accounted for 39%, with UK accounting for 14% of exports, and the USA accounting for a further 24%, our reliance on traditional European and US markets thus remains too high. The decision by the UK to leave the EU, and the uncertainty that this brings to Irish exporters, highlights more than ever the need to support Irish exporters in the diversification of their export markets so that an over-reliance on any particular single market does not have the potential to put our economy under a similar threat in the future.”* The impact of the sales-by-destination factor on the tax base that would be allocated to Ireland is clear.

Interestingly and by exception, where the outcome of the apportionment does not fairly represent the extent of business activity, a “safeguard clause” provides for an alternative method of income allocation. As the general scheme of the formulary apportionment cannot address the specificities of certain industries, there will be rules on adjusted formulae, in order to better fit the needs of sectors such as financial services and insurance, oil and gas, as well as shipping and air transport.

There are certain transitional rules and measures regarding reorganisations and withholding taxes, but the main measure is that of formulary apportionment. That gives rise to the most concern from an Irish perspective and one that Ireland has consistently objected to.

The proposed directive is required to be adopted by Member States by 31 December 2020 and the provisions should apply from 1 January 2021 if the directive is passed.

Hybrid mismatches with third countries

The issue of hybrid mismatches has been dealt with in the ATAD and indeed as part of the CCTB as discussed above. Separately, the European Commission proposed a directive to amend the ATAD to deal with hybrid mismatches with third countries. The proposed directive deals with the following types of mismatch:

(1) Hybrid entity
(2) Hybrid financial instrument

(3) Hybrid transfers
(4) Hybrid permanent establishments
(5) Imported mismatches
(6) Dual resident.

The proposed directive has detail in connection with each of the above mismatches and outlines certain examples of mismatches. In general, the purpose of the directive is to eliminate double deductions or indeed deductions without inclusion in tax bases. For example, in the case of a hybrid entity mismatch between a Member State and a third country, the Member State concerned should deny the deduction of the payment, expenses or losses irrespective of whether the payment has its source in the Member State or in the third country, unless the third country has already done so. In the case of such mismatch resulting in a deduction without inclusion between a Member State and a third country, it should be established first which is the jurisdiction of the payer. If the jurisdiction of the payer is a Member State, that Member State should deny the deduction of the payment from the taxable base to the extent of the mismatch. If the jurisdiction of the payer is a third country, the Member State concerned should provide for a rule that requires the taxpayer to include the payment in the taxable base to the extent of the mismatch.

The proposed directive is required to be adopted by Member States by 31 December 2018 and the provisions should apply from 1 January 2019 if the directive is passed.

Dispute resolution rules in double taxation for businesses

The proposed directive builds on the terms of the Convention on the Elimination of Double Taxation in connection with the adjustments of profits of associated enterprises in the EU Arbitration Convention. Once implemented, the directive notes that it *"will reinforce mandatory binding dispute resolution in the EU"*.

The proposed directive allows for a Mutual Agreement Procedure (MAP), initiated by the taxpayer under which the Member States will cooperate to reach agreement on the double taxation dispute within two years. If the MAP fails, a dispute resolution procedure follows with the issuance of a final mandatory, binding decision by the competent authorities of the Member States involved. The proposal outlines formal rules to clarify the conditions under which a complaint shall be admissible to the MAP (i.e. the time frame for the complaint, the explanation of the double taxation situation by the taxpayer and the provision of the information in order to enable the competent authorities to examine the case and to consider its admissibility).

There is also an automatic arbitration procedure which foresees solving the dispute by way of arbitration within a timeline of fifteen months where Member States failed to reach an agreement during the initial phase. Situations where both Member States do not agree on admissibility of the taxpayer's case to the MAP phase can also be submitted to arbitration at an earlier stage, so as to solve this conflict on admissibility of the case provided that the taxpayer requests it and establishes that it has renounced domestic remedies or that the recourse period for such remedies has expired. Under this supplemental arbitration procedure, a panel of three to five independent persons have to be appointed (one or two for each Member State, plus one independent chair), together with two representatives of each Member State. This 'Advisory Commission', issues a final opinion on eliminating the double taxation in the disputed case, which would be binding for Member States, unless they agree on an alternative solution to remove the double taxation. A default fast-track enforcement mechanism supervised by the competent national courts of each Member State involved is created where the Advisory Commission is not set up within a certain time limit. The taxpayer would have the possibility to refer to the national court in this case, to appoint the independent persons who would then chose the chair. The independent persons and the chair will be chosen from a pre-established list maintained by the European Commission. The directive outlines the procedural frameworks involved.

The proposed directive is required to be adopted by Member States by 31 December 2017, if the directive is passed.