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Bridging the CCCTB and the Arm's Length Principle – A Value Chain Analysis Approach

This article provides an analysis of the proposals for a common consolidated tax base (CCTB) and common consolidated corporate tax base (CCCTB) in the European Union in the context of transfer pricing, concluding that a value chain analysis approach is the only possible means of aligning the CCCTB rules with the arm's length principle.

1. Introduction

1.1. Introductory remarks

Formulary apportionment models of taxation have often been proposed as a means to resolve current tax planning leakages and conflicting positions regarding the interpretation of tax treaties. The emblematic example of formulary apportionment, often referred to as "unitary taxation", practised amongst jurisdictions such as the United States and Canada, has provided the inspiration for the creation of a peculiar EU variety of formulary apportionment.

Following an initial common consolidated corporate tax base (CCCTB) proposal in 2011, a proposal for a modified CCCTB,[1] which is to be preceded by an initial stage of harmonization (the common corporate tax base (CCTB))[2] was introduced by the European Commission in October 2016. The Proposed CCCTB Directive provides for a single set of rules designed to facilitate the calculation of taxable corporate profits in the European Union. The motivation for the renewed launch of this initiative by EU officials was the need to make corporate taxation fairer, more competitive and more growth-friendly. Although the reintroduction of the CCCTB has faced criticism, the Commission considers the initiative to be an inevitable step towards combating tax avoidance, together with other anti-tax avoidance initiatives,[3] with the ultimate goal being to create a fair and equitable tax environment.

The CCTB/CCCTB work by first harmonizing domestic tax rules, followed by cross-border consolidation and subsequent apportionment of consolidated taxable profits using a predetermined formula that is based upon fixed assets, number of employees/payroll and sales figures. The primary purpose thereof is to eliminate issues related to intra-group transactions and facilitate uniformity by standardizing economic factors, such as currency and applying IFRS regulations. Developments under the OECD's Base Erosion and Profit Shifting (BEPS) Project have, however, urged the competent EU authorities to include anti-BEPS elements into the proposed framework. The goal is to curb aggressive tax planning to the greatest extent possible. To this end, a series of anti-BEPS measures, such as an interest limitation rule based on EBITDA (earnings before interest, taxes, depreciation and amortization), a switch-over clause, CFC rules, hybrid mismatch rules and a general anti-abuse rule have been included in the proposals.

1.2. Scope and purpose of the article

The principal purpose of this article is to examine how a value chain analysis approach is the only possible means of aligning the CCCTB rules with the arm's length principle. The article begins in section 2. with an analysis of the status of the CCTB and CCCTB proposals and discusses further in section 3. the pre-requisites for a successful launch of the proposal in the European Union. Section 4. covers the differences between the Proposed CCCTB Directives, the EU Anti-Tax Avoidance Directive (2016/1164) (ATAD) and the BEPS Project on issues such as the PE rule, CFC rules and hybrid mismatches. Subsequently in section 5. the authors address how allocation keys under the CCCTB appropriately reflect specific economic circumstances. A few quantitative examples on the application of the CCCTB are then provided, both in respect of EU and non-EU operations. Subsequently in section 6. a comparative analysis of the CCCTB and the OECD Model methods to avoid double taxation is provided. In section 7. the authors seek to examine how the CCCTB rules can be combined with domestic tax law in order to address challenges that might arise in transitioning to the new regime. Ultimately in section 8 the article analyses the extent to which a value chain analysis can constitute a solution to the challenges discussed in the article resulting from application of the CCCTB.

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The authors would also like to thank Rita Botelho Moniz from Cuatrecasas (Lisbon) for her contribution to the article.

1. Proposal for a Council Directive on a Common Consolidated Corporate Tax Base, COM(2016) 683 final (25 Oct. 2016), EU Law IBFD (the Proposed CCCTB Directive).
2. Proposal for a Council Directive on a Common Corporate Tax base, COM(2016) 685 final (25 Oct. 2016), EU Law IBFD (the Proposed CCTB Directive).
3. Council Directive 2016/1164 of 12 July 2016 Laying down Rules against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, OJ L 193/1 (2016), EU Law IBFD.

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The authors are of the opinion that, to the extent that the CCCTB and BEPS initiatives are both based on a "value creation" analysis, a bridge can be established between BEPS/OECD profit allocation principles and the CCCTB, with its formulary-based profit allocation.

2. The CCTB and CCCTB: A Common (Consolidated) Corporate Tax Base

2.1. The CCTB proposal

The Proposed CCTB Directive contains a CCTB system that provides for a common standard to be observed by corporations established under the laws of a Member State, or a permanent establishment (PE) of a corporation with activities in the European Union. Corporations that meet certain conditions, are part of a consolidated group with group revenue exceeding EUR 750 million and are qualified as a parent or subsidiary or have a PE in another Member State(s), will be subject to the proposed CCTB measures.

The CCTB is the first step of a two-pronged process that provides for common principles for the establishment of a single set of detailed rules to calculate the tax base of the relevant companies. More specifically, the CCTB proposal provides for rules on the depreciation of assets, deductible expenses, exempt revenues, provisions, valuation, loss carry-forward and exit taxation.

In addition, the CCTB proposal refers to the EU Anti-Tax Avoidance Directive (2016/1164) (ATAD), which is intended to combat specific topics concerning BEPS structures, as recommended by the OECD, rules on entering and exiting the regime and transactions between associated enterprises.

Finally, the proposal launches an Allowance for Growth and Investment (AGI) incentive, aimed at relieving the asymmetry between interest payments and dividend distributions by facilitating deductibility in respect of increases in equity under certain conditions and provides a super deduction for research and development (R&D) expenses.

Whereas the CCTB is mandatory for larger groups of companies (i.e. those that meet the aforesaid conditions, including the EUR 750,000.000 revenue threshold), small and medium-sized enterprises are not obliged to follow the rules, but may opt, under certain conditions, to apply the rules of the Directive for successive periods of five years.

With regard to the threshold, it should be noted that the European Trade Union Confederation found the EUR 750 million revenue requirement to be too high and proposed that it be set at a maximum of EUR 40 million instead.[4]

2.2. The CCCTB proposal

As a second step in determining the tax base of qualified companies under the EU corporate tax harmonization project, a proposal for a common consolidated corporate tax base (CCCTB) was introduced in 2016.

The CCCTB is intended as the final stage in the completion of a new system of corporate taxation. This proposal introduces a tool for a common consolidated tax base that includes both consolidation and formulary apportionment among group members. The consolidation enables group companies to effect automatic cross-border loss relief and is intended to abolish transfer pricing disputes between EU Member States.

Taxpayers who mandatorily follow the CCTB rules are obliged to follow the prescriptions of the CCCTB as well. Further, the "all in or all out" principle applies, which means that any group member subsidiary or PE, qualifying for group consolidation according to the relevant sections of the Proposed CCCTB Directive, by definition is included within the scope of the regime.

Formula apportionment applies three-factor revenue split to the respective group member companies. The relevant factors are assets (i.e. fixed tangible assets), labour (divided into a headcount and payroll component) and sales, each of which is accorded equal weight. If the outcome of the formula does not fairly represent where profits are generated, a request may be filed to use an alternative method.

In a nutshell, the proposal provides for a One-Stop Shop system attributing competency mostly to the principal tax authority of the Member State in which the principal taxpayer is located, which is typically the tax authorities in the parent entity country. The way in which this proposal is designed, in particular the fact that it ignores the existence of intangible property, does not allow, however, for a proper allocation of the profit of each group company.

2.3. The French and German approach

On 16 August 2016, France and Germany announced their mutual commitment to introduce and apply a CCTB system as from 2019, including a common tax rate for companies located in their territory. Under this approach, there is no consolidation requirement, i.e. each country would keep the tax revenues generated locally and each country's profit calculation would follow similar standard rules.

Various stakeholders do not, however, endorse this proposal. For example, Business Europe[5] has voiced its concern that a CCTB proposal does not end competition and does not mitigate the substantial compliance costs associated with the documentation burden under EU transfer pricing rules, which will remain. In addition, Business Europe is of the opinion that the initial loss offset is not sufficiently comprehensive to replace full consolidation.

4. *See* http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/599395/EPRS_BRI(2017)599395_EN.pdf, p. 10.

5. *See* https://www.businesseurope.eu/publications/common-corporate-tax-base-cctb-and-common-consolidated-corporate-tax-base-ccctb.

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3. Prerequisites for the Application of the CCTB and the CCCTB

3.1. In general

The CCTB and the CCCTB proposals provide for different rules. In section 3. the article identifies the prerequisites for the application of a common (consolidated) corporate tax system.

3.2. One functional currency

Under the Proposed CCTB Directive (article 20(2)), once there is a group company in an EU Member State, the whole group is required to apply the euro as its functional currency. This functional currency rule does not, however, apply under the CCCTB if all group members are located in Member States that have not adopted the euro, in which case the principal taxpayer shall determine which currency applies.

Given this opening into the use of other currencies, one might wonder whether the CCTB and the CCCTB would allow for the use of other currencies as the functional currency, for example, the pound sterling or USD, which would be attractive to non-EU investors, as well as to certain industries that typically apply specific currencies (for example, in the oil & gas industry the USD is mostly used).

3.3. One internal market: The EU freedoms and key principles

The EU "single market" is dependent on the four fundamental EU freedoms: the free movement of goods, the freedom of establishment for EU citizens, the freedom of capital and the freedom of services as enshrined in the Treaty on the Functioning of the European Union (TFEU) (2007).[6]

The CCTB and CCCTB proposals aim to restrict multinationals from artificially shifting profits between Member States by requiring that a genuine commercial purpose underlie their intra-group transactions (for example, building a new factory in another Member State, or even worse, moving all production hubs in the European Union to one Member State based on pure economic considerations).

This might, however, conflict with the four freedoms, as well as case law of the Court of Justice of the European Union (ECJ) interpreting these freedoms.

In the authors' view, exploitation of EU freedoms by EU taxpayers should not automatically be viewed as a sign of aggressive tax planning, but instead as the first pillar of any "internal" market. For example, companies that set up their structures in such Member States, with the result that the tax conditions are beneficial, should not inevitably be seen as having an artificial scheme. Under the freedom of establishment, they have the right to explore (freely) their business options within the European Union. Furthermore, implementing a common (consolidated) corporate tax base will jeopardize certain key EU principles. In statements made by the national parliaments of Bulgaria, Denmark, Ireland, Luxembourg, Malta, the Netherlands, Poland and Sweden, it was argued that the proposals violate the principles of subsidiarity and proportionality enshrined in article 5(3) and (4) of the Treaty on European Union (TEU) (2007),[7] respectively.

In short, as the principle of subsidiarity determines when the European Union is competent to legislate, and the principle of proportionality regulates the extent of the exercise of powers by the European Union, it was argued that the objectives of these proposals can be achieved sufficiently by the Member States and that the proposed measures, taken at an EU level, exceed what is necessary to achieve the intended objectives.

It should be borne in mind that tax sovereignty is a fundamental aspect of national sovereignty. Member States have direct competence in respect of direct tax matters and, therefore, have the right to design their tax systems in the manner that best serves their national goals and combats their weaknesses. For example, some Member States cannot rely on having an ideal geographic location, high-quality infrastructure, optimal agricultural and meteorological conditions or a highly qualified work force. Therefore, they need to find other ways to attract foreign investment. Ireland's tax system, for example, is seen as one of the cornerstones of the Irish investment climate.

Before implementing any new anti-BEPS rules, the European Union must ensure that the outcome of any anti-BEPS Project meets the needs of the internal market and respects the Treaty freedoms. A common corporate tax base definition would not respond to all BEPS issues, for example, non-taxation of companies that provide valuable IP contributions to the business operations of the MNE.

3.4. One consistent accounting standard: A pan-European IFRS for tax purposes

The EU-wide applicability of International Financial Reporting Standards (IFRS) for listed firms can be seen as facilitating the application of a common (consolidated) corporate tax base. Thus, under the CCCTB proposal, all members of the taxable unit are expected to calculate their own tax bases first and then apply common tax accounting rules. The argument is that this process reduces compliance costs and increases transparency. This means that companies that have a currency that is different from the group's currency should convert their individual tax base to the group's currency. In this respect, the parent company's currency should be decisive. In general, the exchange rate on the respective tax accounting date should be used to convert the taxable income. Similarly, there would be a common denominator, i.e. the use of differentials in the countries' definitions of taxable unit and tax base, as well

6. Treaty on the Functioning of the European Union of 13 December 2007, OJ C115 (2008), EU Law IBFD.

7. Treaty on European Union of 13 December 2007, OJ C 306 (2007), EU Law IBFD.

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as tax base allocation mechanisms, for a pan-European corporate tax base.

One should keep in mind, however, that not all EU Member States have adopted the IFRS and, therefore, some have different tax bases. In requiring a common accounting standard, the CCCTB proposal does not recognize each Member State's rules regarding financial statements. Companies all over the European Union, independent of their size, would then have to restate their financial statements in IFRS, resulting in significant costs that are, in fact, unnecessary. Furthermore, further adjustments would still be needed, increasing the administrative burden on the taxpayer's side even more (for example, new calculations of stock valuations), causing an inequality of treatment of IFRS and non-IFRS companies. It is arguable that the extent of this burden would depend on the degree of difference between local GAAP and IFRS, although new calculations (and respective audits) would always be necessary.

3.5. A neutral and economically relevant set of allocation keys

The CCCTB proposal establishes formulary apportionment as the mechanism to determine the tax base, through the use of an allocation key, whereby profits at the European level are consolidated and then allocated to each Member State. As mentioned in section 2.2., this allocation key is based on three equally weighted factors: labour (including payroll and the number of employees), assets (including all fixed tangible assets. It does not consider intangibles and financial assets on the basis that these are mobile and thus easier to manipulate) or sales by destination.

Additionally, certain special rules might come into play. A safeguard provision applies if the outcome does not fairly represent the extent of the business activity. There are also rules applicable to certain industries (i.e. the oil & gas, shipping, insurance and financial services industries). In an EU context, however, could the application of different corporate tax rules to specific industries be qualified as unlawful State aid? Each industry has its own characteristics in terms of value chain. How should this be dealt with?

Furthermore, such a set of profit allocation keys is not in line with international tax rules, the OECD transfer pricing guidelines for multinationals or the BEPS-principle of substance and value creation, as it does not take into account the place where value is actually created for the purposes of taxing profit. Thus, it does not reflect current business models or economic reality. In particular, the proposed allocation key ignores value creation through intangibles and financial assets, resulting in a disadvantage for more modern economies that feature these developments. One should not forget the increasing role of digital economy, which results in profits being realized in locations with little payroll or (tangible) assets. The biggest and most profitable businesses operate in this arena and the CCCTB basically ignores their existence. A way must be found to tackle this issue and understand where real value is being generated. The fact that a company lacks tangible assets or people does not necessarily mean it lacks profits.

For example, (smaller) countries with an innovative services sector would have difficulties in building up a tax base. Also, it would become more difficult for smaller EU Member States, with small domestic economies, to remain competitive. This is because having the sales factor included in the allocation key, with the same weight as labour and capital, could result in substantial revenue loss for these countries. For example, deeming sales to be made at the place of destination could potentially affect the overall economic environment in smaller Member States, for example where they try to compensate for the decline in tax revenue by raising corporate and investment taxes. This allocation key could not only potentially create more tax disputes between EU Member States and third countries, causing more instances of double taxation, but could also be disruptive from an investment perspective.

In a nutshell, the authors believe that the profit allocation keys under the CCCTB are too simple and do not take into account intangible assets, functions and risks, which are determinants of a proper understanding of value creation within a group. Furthermore, for a large number of industries and activities, an arm's length allocation of profits would not be followed, causing legal uncertainty for certain activities, potentially resulting in double or no taxation.

Another consideration is the time and effort it will take to amend all of the tax treaties between Member States to explicitly allow for a deviation from the arm's length principle and replace it with the CCCTB profit allocation keys. A second multilateral instrument (MLI 2) could be considered to prevent the need to redraft these bilateral tax treaties.

3.6. An adequate understanding of "value creation" by international operations

As explained in section 3.5., the CCCTB uses a formula based on three equally weighted factors (i.e. assets, labour and sales), viewing these as determinants that explain exactly where the real economic activity is and where value is created. It views certain other factors as easier to manipulate into aggressive tax planning strategies.

In applying such a simplified understanding of "value creation", however, the CCCTB ignores a large and growing segment of value creation by companies, namely intangible and financial assets, for the simple reason that these factors are seen as "mobile". How, for example, should Google's European profits be allocated based on the CCCTB, given that the fixed assets involved in running its business are limited. From the authors' perspective, this denies the business realities of today's world.

In doing so, instead of encouraging business investment and creating employment, the European Union will simply incentivize a re-definition of tax planning within the European Union, as well as increase the administrative burden on the companies forced to apply such measures.

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3.7. EU implications of variable speeds of integration

Germany and France are the main supporters of the implementation of a CCTB and a CCCTB. As mentioned in section 2.3., other Member States have objected to the introduction of the proposed rules on the basis of the EU fundamental pillars, as well as the need to maintain and further develop a business-friendly, "free" internal market.

Furthermore, some Member States object to the proposals due to the particular obstacles they face in attracting investment. Also, at a macroeconomic level, some of these Member States will suffer from an antagonistic effect, i.e. they will have less tools in the arena of tax to attract investment.

Moreover, this will create a disadvantage for countries that are highly specialized in certain industries, such as Spain in relation to its operation of a vast conglomerate of assets in the production and distribution of fruits and vegetables. In this case, it will be creating foreign direct investment (FDI) dilemmas. For example, it will have to be decided whether this industry should invest in a higher asset base and/or more people to maintain a stable "tax base" in Spain under the CCCTB formula. Again, tax becomes a major driver in terms of where and how to invest in the European Union.

4. The CCTB/CCCTB versus the BEPS Project and the ATAD

4.1. In general

The CCTB, CCCTB, BEPS and ATAD initiatives have in common the goal of introducing measures to prevent tax base erosion, avoidance and abuse. In any event, it seems, to the authors, that some of the measures proposed in respect of the CCTB and the CCCTB, as well as some of those applicable under the ATAD, go even further than those recommended as part of the OECD BEPS Project, and thus tackle not only structures intended to achieve BEPS, but also structures rooted in significant business strategies and purposes.

4.2. The PE rule

With regard to the PE concept, it should be noted that article 5 of the OECD Model (2014),[8] Action 7 of the BEPS Plan and article 5 of the Proposed CCTB Directive are all aimed at preventing the artificial avoidance of PE status. They tackle avoidance through commissionaire arrangements and similar strategies, as well as specific activity exemptions, by establishing a proper allocation of profits to a PE.

The CCCTB proposal, however, does not provide for such a provision, as all PEs located in Member States would be included in the consolidation based under article 6(1)(a) and 6(b) of the CCCTB proposal. The ATAD does not include a provision on PEs.

4.3. The controlled company rule

In order to properly allocate profits and avoid the shifting of profits from one Member State to another, a provision on controlled companies is included. A controlled company exists where there is a holding of more than 20% of the voting rights or a participation of more than 20% in the capital of a company. Under the ATAD the threshold is 25%, which is increased to 50% with regard to hybrid mismatch situations.

Such participations are presumed to put the holder in a position to exercise significant influence over the management of the other company. If such a relationship exists, it must be ensured that the arm's length principle is being respected and that the relevant transactions are based on conditions that would have been agreed between independent enterprises. If this is not the case, transfer pricing adjustments will be made.

In addition, under all of the EU measures and the BEPS Project various anti-abuse provisions are included that are similar, but not identical. Except for a general anti-abuse provision and an interest limitation rule, the CCTB proposal refers to the specific anti-abuse provisions of the CCCTB proposal. The provisions included in the CCCTB proposal are, to a large extent, similar to those of the ATAD and the BEPS Project.

4.4. The CFC rule

The CCTB, CCCTB, ATAD and Final BEPS Reports include an important anti-abuse rule concerning controlled foreign company (CFC) legislation, which aim to combat the shifting of profits to controlled companies that are subject to a lower tax rate or that benefit from a special regime.

The definition of a CFC is the same under all of the EU proposals. What is key is for the parent companies to have a decisive influence over the foreign subsidiary. This is deemed to be the case if the taxpayer alone, or together with its associated enterprises, holds a direct or indirect participation of more than 50% of the voting rights, owns directly or indirectly more than 50% of the capital, or is entitled to more than 50% of the profits of the foreign company.

Moreover, the tax rate applicable to the CFC must be lower than that of the parent company. Under the CCTB and CCCTB proposals what is decisive is if the rate is lower than the rate applicable under the Directive, less the actual tax paid by the CFC. In that instance, the income of the foreign company is included in the income of the parent company.

With regard to CFC rules, the CCTB, CCCTB and ATAD initiatives go further than the recommendations of the Final BEPS Report on Action 3.[9] While the Final Report on Action 3 specifies that CFC income includes dividends,

8. *OECD Model Tax Convention on Income and on Capital* (26 July 2014), Models IBFD.

9. OECD, *Action 3 Final Report 2015 – Designing Effective Controlled Foreign Company Rules* (OECD 2015), International Organizations' Documentation IBFD, also available at http://dx.doi.org/10.1787/9789264241152-en.

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interest, insurance income, royalties and IP income and sales and services income, the definitions under the CCTB and CCCTB proposal and the ATAD, as adopted, are broader. The definition under the EU measures also covers income generated by financial assets, from a disposal of shares, from financial leases and from banking and other financial activities. Losses of a CFC are not taken into account immediately, however, but in subsequent years.

In any event, the CFC rules do not apply in several instances. First, CFC rules do not apply if the foreign company is set up for valid commercial reasons that reflect economic reality. A clear indication that it has enough substance is if it has commensurate staff, equipment, assets and premises. The ATAD indicates that Member States may decide not to apply this general carve-out rule to third countries outside the European Economic Area.

Second, with regard to PEs, CFC rules do not apply if the CFC income does not constitute more than one third of total income. Additionally, the ATAD includes a safe harbour clause, pursuant to which CFC rules do not apply to a PE if its accounting profits and non-trading income do not exceed EUR 75,000 or the accounting profits are no more than 10% of operating costs for the taxable period.

4.5. The hybrid mismatch rule

The hybrid mismatch concept under the CCTB, CCCTB, BEPS and ATAD is similar. It is intended to avoid a double deduction of the same payment, expense or loss, as well as deduction/non-inclusion situations. With regard to a double deduction, a deduction should only be granted in the source state. If a payment is not taxed in the residence state, the source state should deny the deduction. If the payment originates in a third country, the Member State of the recipient has to include the income in its tax base unless that state has denied the deduction. The same rules apply with regard to deduction/non-inclusion situations.

While under the CCTB the hybrid mismatch rules also apply to PEs, the CCCTB limits the scope of this rule to relations between group members and non-group members that are associated enterprises. A comparable rule also applies in respect of payments by a company established in an EEA Member State to an associated company in a third country. With regard to a double deduction or deduction/non-inclusion situations, the Member State concerned will deny the deduction unless the other country has already denied the deduction.

Finally, Action 2 of the BEPS Report and the CCTB proposal contain a special anti-abuse provision for dual-residency mismatches.[10] If a company is resident in both an EEA Member States and a third country, the Member State will, generally, deny a deduction for payments resulting in a double deduction, unless the third country has already denied the deduction.

4.6. The switch-over clause

Both the CCTB and CCCTB proposals include a switch-over clause. Under this rule, foreign income received from an entity in a third country will not be exempt if the statutory tax rate of that country is less than half of the statutory rate of the Member State concerned.

It is unlikely, however, that this clause will be retained in the final proposal, as it was deleted from the final text of the ATAD due to opposition from various Member States. The Netherlands, for example, has opposed such a rule on the basis that it constitutes an excessive limitation of the participation exemption and would make the Netherlands less attractive to foreign headquarters. In contrast to the Netherlands participation exemption, the switch-over clause does not contain a provision on liquidation losses.

4.7. The interest barrier rule

The payment of excessive interest was often used as a method for reducing the tax base. In many states, this was already countered under domestic law through thin capitalization rules, pursuant to which companies are limited to a set amount of debt, determined by an equity ratio or safe harbour rule. In many states, however, the thin capitalization rules have been replaced by an EBITDA rule under which borrowing costs may not exceed a set percentage of the taxpayer's earnings before interest, tax, depreciation or amortization or a safe harbour amount.

The EBITDA concept is also included under the CCTB, CCCTB and ATAD and is also in the Final BEPS Report on Action 4.[11] Under the CCCTB proposal, however, the interest limitation is calculated at the level of the group. Furthermore, this rule appears to be stricter under the EU proposals than in Action 4, since under all EU measures, the EBITDA rate is fixed at 30%, whereas Action 4 recommends a percentage of between 10% and 30%.

In addition, in deviation from Action 4, all EU measures contain a safe harbour amount. This amount varies among the EU proposals: EUR 3 million under both the ATAD and the CCTB proposal and 5 million under the CCCTB proposal.

Finally, both BEPS Action 4, as well as the ATAD, provide for the application of a group ratio rule. The group ratio is based on a two-stage test: first, the group's net third-party interest/EBITDA ratio must be determined and second, the ratio must be applied to the company's EBITDA.

Furthermore, the ATAD allows for a company's ratio to be 2% lower than that of the group and all assets and liabilities must be valued in the same manner.

4.8. Exit taxation

Contrary to the OECD BEPS package, both the ATAD, as well the CCTB, contain a provision on exit taxation. Under

10. OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (5 Oct. 2015), International Organizations' Documentation IBFD.

11. OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (5 Oct. 2015), International Organizations' Documentation IBFD.

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the CCCTB proposal, special provisions are included with regard to leaving a multinational group.

Article 29 of the CCTB proposal provides that, in the event of assets leaving the group, the difference between the fair market value of the asset and the value for tax purposes is included in the tax base if one of the following circumstances arises:

– a transfer of assets from a head office to a PE in another Member State or a third country;
– a transfer from a PE in a Member State to its head office or another PE in another Member State or in a third country, to the extent that the Member State of the PE no longer taxes the transferred assets;
– a transfer of tax residence to another Member State or third country, except for assets that remain effectively connected with that company in its previous residence state; and
– a transfer of the business of a PE to another Member State or a third country, to the extent that the previous Member State of the PE no longer has a right to tax the transferred assets.

The new Member State of the company or PE will carry over the value that the assets had in the previous residence state.

Finally, as an exception to the main rule, the exit taxation rules do not apply to asset transfers in one of the following situations:

(1) assets related to the financing of securities;
(2) assets posted as collateral;
(3) asset transfers undertaken in order to meet prudential capital requirements; and
(4) asset transfers for the purpose of liquidity management where those assets are set to revert to the Member State of the transferor within a period of 12 months.

Article 19 of the CCCTB proposal contains a special provision for fixed assets and financial assets leaving a multinational group. The proceeds of non-depreciable or individually depreciable fixed assets are included in the consolidated tax base of the group if they are disposed of within three years of the departure from the group by the economic owner of the assets. The taxable amount will be reduced by the costs related to non-depreciable fixed assets and the value for tax purposes of individually depreciable fixed assets. Only proceeds from own shares and or participations that give rise to tax-exempt income are not included in the consolidated tax base.

With regard to self-developed assets, article 20 of the CCCTB proposal provides that an amount equal to the costs incurred in respect of these assets for research, development, marketing and advertising in the previous five years is to be added to the consolidated tax base of the tax year that a company leaves the group.

5. The Application of the CCCTB

5.1. The principle of neutrality: allocation keys

The CCCTB contains a special paragraph on the apportionment of the CCCTB. Revenue will be shared on the basis of formula apportionment, under which equal weight is given to the three factors: sales, labour and assets. The consolidated tax base is allocated by a formula. This formula consists of three parts.

$$\Pi_i = \left(\frac{1}{3}\frac{S_i}{S_{grp}} + \frac{1}{3} * \left(\frac{1}{2}\frac{P_i}{P_{grp}} + \frac{1}{2}\frac{NE_i}{NE_{grp}}\right) + \frac{1}{3}\frac{A_i}{A_{grp}}\right) * CCCTB$$

1/3 of the sales of a group company/sales of the entire group + 1/3 of (50% of the payroll of a group company/ payroll of the entire group and 50% of the number of employees of a group company/number of employees of the entire group) + 1/3 of the assets of the group company/ assets of the group). The outcome of this formula is multiplied by the consolidated tax base.

As shown in the examples in section 5.2., the CCCTB is based on a fixed apportionment formula. The CCCTB, therefore, has the potential of reducing compliance costs, resulting in more transparency and avoiding issues of double taxation and double non-taxation due to qualification differences, as well as reducing the need for transfer pricing documentation. Furthermore, it might simplify cross-border restructuring and the offsetting of cross-border losses.[12]

Despite these possible advantages, however, there are certain risks to revenue, as it is possible to manipulate the outcome of the formula. The outcome of the labour factor can be manipulated, as companies can decide when and where activities are carried out and, in particular, which company pays the salaries.

The allocation of labour deviates from the OECD BEPS Plan principles. What is decisive is which company pays the salary. The fact that a company is located in a Member State other than the State where the employment is carried out is irrelevant. Under the Final BEPS Report on Action 5,[13] regarding harmful tax competition, revenue and costs are allocated where value is created, meaning the Member State where the employment activities are performed. Consequently, the "labour" factor under the CCCTB seems to be much more mobile.

The "capital" factor can be influenced by sales and purchases of assets at the end of the year that are aimed at shifting profits to Member States with a lower tax rate.[14]

12. *See* T. Rödder, *Wo steht und wohin entwickelt sich das Europäische Unternehmenssteuerrecht?*, in *Festschrift Herzig* p. 359 (W. Kessler, G. Förster & C. Watrin eds., C.H. Beck 2010),
13. OECD, *Countering Harmful Tax Practices More Effectively – Action 5: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (5 Oct. 2015), International Organizations' Documentation IBFD.
14. As stated by David Spencer in his presentation on how the use of a formulae based profit allocation between the states in the United States has been heavily modified on a state-by-state basis, leaving lots of planning opportunities for corporates; 4th Global Tax Policy Conference, Maastricht University, 19 June 2017.

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The "sales" factor is based on the destination principle, included in article 38 of the Proposed CCCTB Directive. Therefore, it seems to be the only factor that is more difficult to manipulate. With regard to a group's planning possibilities involving intangibles, however, these could, for example, be allocated to Member States with low-tax rates such as Ireland.

In addition, as long as significant differences continue to exist in terms of tax rates, the choice of which Member State a company should be established in will continue to be partially tax driven.

The above possibilities for manipulation are only, to a certain extent, mitigated through the specific rules in articles 40 to 43 of the Proposed CCCTB Directive for financial institutions, insurance undertakings, oil & gas operations, as well as shipping and air transport.[15]

Furthermore, a major shortcoming is that intangible and financial assets are not taken into account despite the fact that an increasing percentage of the profits of many companies is derived from IP. This means that the current formula is mainly to the advantage of Member States with labour-intensive industries and could result in revenue loss for Member States in which the service industry plays an important role.

The Commission has acknowledged the possibilities for manipulation, in that article 39 of the Proposed CCCTB Directive indicates that the Commission may adopt detailed rules on the calculation of the labour, asset and sales factors, the allocation of employees and payroll and assets and sales to the respective factor, as well as the valuation of assets in the context of an examination procedure under the CCCTB.[16]

5.1.1. The CCCTB allocation keys versus "return on fixed assets", "return on intangibles" and "return on non-intangible premium"

The overall group's results are allocated on the basis of who – i.e. which group entity – owns and/or controls the group's assets. This is determined by qualifying/quantifying each entity's position.

Generally, multinationals engage in business that employs three categories of assets: fixed/tangible assets, intangible assets and non-intangible premiums (for example, location savings, assembled workforce and synergies).

A return on fixed/intangible assets can be determined through a "cost-plus" or "return on assets" method. Intangibles, however, generate a return on investment, typically in the form of royalty or lump-sum payments. One should keep in mind that an intangible only appears in an entity's balance sheet to the extent that the intangible is recognized for accounting purposes.

Lastly, non-intangible premiums are usually addressed through geographically specific factors. Bargaining theory and practices are used to determine how such premiums get allocated between group companies. This category of assets/activities also does not show up on a balance sheet, as no accounting standards have been developed to capitalize such assets (for example, R&D workforce).

This "value chain analysis" approach is compared with the CCCTB proposal in section 8. of this article.

5.2. The workings of the CCCTB – How the numbers work in practice

The easiest way to explain the effects of the CCCTB proposal is to examine how it works in practice, which is demonstrated by means of the following examples:

Example 1

Member State A allows assets to be depreciated over ten years, for tax purposes, while Member State B allows for depreciation over five years. Member State A allows for a deduction for all entertainment expenses, while Member State B does not.

A common corporate tax base means that these rules would be the same throughout the European Union and companies would only need to do their calculations based on one set of tax rules.

Without consolidation, the company would need to make a separate calculation and file a separate tax return for each Member State in which it has a taxable presence. This would still be easier than today, however, as the rules for this calculation would be uniform across all Member States.

Under the proposed consolidation, all profits and losses from the companies of a group in different Member States would be totalled in order to calculate a net profit or loss for the group's entire EU activity. Based on this net figure, common rules would be used to determine the final tax base of the group.

Example 2

A group consists of companies A, B, C and D, each in a different Member State.

Companies A and B have profits of EUR 10 million each, Company C has a profit of EUR 5 million and Company D has a loss of EUR 8 million.

The consolidated tax base (net profit) of this group is A + B + C – D = EUR 17 million.

This profit must then be apportioned between the relevant Member States. *See further* for country specific allocations of the consolidated tax base.

15. For financial institutions, the asset factor is fixed at 10% of the value of financial assets, with the exception of own shares and of participations that give rise to tax-exempt income, while the sales factor is 10% of its revenue in the form of interest, fees, commissions and revenue from securities, excluding value added tax, other taxes and duties. For insurance companies, the asset factor is the same as for financial institutions, while the sales factor is 10% of all earned premiums, net of reinsurance, allocated investment returns transferred from the non-technical account, other technical revenue, net of reinsurance, and investment revenue, fees and commissions, excluding value added tax, other taxes and duties. Sales of a group member conducting its principal business in the field of the exploration or production of oil or gas is to be attributed to the group member in the Member State where the oil or gas is to be extracted or produced. Finally, the revenues, expenses and other deductible items of a group member whose principal business is the operation of ships or aircraft in international traffic or the operation of boats engaged in inland waterways transport is to be excluded from the consolidated tax base and not apportioned.
16. *Supra* n. 14.

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5.3. CCCTB application involving only EU operations

The following two examples illustrate the application of the CCCTB to companies that operate exclusively in the EU market:

Example 3

Assume Company A has its place of business in the Netherlands. It has subsidiaries in States A and B. It is presumed that the parent company in the Netherlands earns a profit of 100, while the subsidiary in State A suffers a loss of 60 and the subsidiary in State B earns a profit of 80. Furthermore, it is presumed that the corporate income tax rate in all three States is 25%. In applying the CCCTB, States A, B and C attract an equal portion of the CCCTB.

The tax consequences of Example 3 are as shown in Table 1.

Table 1: CCCTB in practice involving only EU operations

Country	Local result	CIT	CCCTB result	CIT
Netherlands (A)	100	25	40	10
Member State B	–60	0	40	10
Member State C	80	20	40	10
Total	120	45	120	30

Example 4[17]

The tax burden of company A, resident in Member State X, equals 3 (10% of 30) (*see* Table 2). The tax burden of company B, resident in Member State Y, equals 18 (30% of 60). The total tax burden is 21.

Table 2: CCCTB in practice involving only EU operations

Country		Member State X	Member State Y
Company A (EU)	Sales	40	
	Payroll and employees	40	
	Assets	40	
	Taxable income	30	
Company B (EU)	Sales		80
	Payroll and employees		20
	Assets		20
	Taxable income		60
Tax rate		10%	30%

Under formula apportionment, the CCCTB consolidated profit is allocated as follows:

Company A = (30 + 60) × (1/3 × 40/120 + 1/3 × 40/60 + 1/3 × 40/60) = 50 of taxable income

Company B = (30 + 60) × (1/3 × 80/120 + 1/3 × 20/60 + 1/3 × 20/60) = 40 of taxable income

The total burden is thus 17, i.e. (10% × 50 + 30% × 40).

5.4. CCCTB application regarding EU versus non-EU operations

The main concerns raised by the Netherlands with regard to the international aspects of the CCTB and CCCTB were outlined in a letter of 18 November 2016. First, following the introduction of the CCTB and CCCTB, Member States will no longer have the possibility to react to international developments and changes to the CCTB and CCCTB, as this would require unanimity. Second, implementation of the CCTB and CCCTB might have a negative impact on the balanced taxing rights agreed to under tax treaties.

In particular, since formula apportionment does not apply to companies established outside the European Union, current tax competition and tax planning regarding third-country investments and transactions might remain under the CCCTB.[18] For instance, deductible interest on a debt transaction might reduce the CCCTB base, although, as explained in section 4.5., there are limits regarding the deductibility of interest.

Profits received from a company established in a third country or proceeds from the disposal of shares in such a company are generally exempt if a qualifying shareholding of 10% in the capital or voting rights of the third company is held for an uninterrupted period of 12 months.

As mentioned in section 4.6., however, a switch-over clause might come into force in respect of dealings with an entity or PE established in a third country. This provision provides that income received as a profit distribution from such a company or as proceeds from the disposal of shares is not exempt if the third company in its residence state is subject to a statutory corporate tax rate of less than half the statutory tax rate to which the EU company would be subject in its country of residence. In this scenario, the tax due on the foreign income will be reduced by the tax paid in the foreign country.

The switch-over clause does not, however, apply if its application is incompatible with a tax treaty with the third country.

Another important aspect concerning dealings with third countries is transfers of assets. Based on article 4(14) of the CCCTB, such a transfer involves an operation whereby a Member State loses the right to tax the transferred assets, which remain under the legal and economic ownership of the same taxpayer. It also includes a situation in which a change in economic ownership takes place.

As mentioned in section 4.8., the Proposed CCTB Directive contains a provision on exit taxation. Such a provision is common in respect of transfers that would lead to a loss of taxing rights for a Member State over the capital gains included in the value of the assets transferred. In contrast, the CCCTB proposal no longer includes an exit provision. Article 24 of the Proposed CCCTB Directive,

17. C. Spengel, Y. Zöllkau & Y. Zöllkau, *Common Corporate Tax Base (CC(C)TB) and determination of taxable income: an international comparison*, study by the Centre for European Economic Research p. 8 (Ernst & Young and Springer 2012).

18. *See*, for a comparison, W. Hellerstein, *Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly*, in *CCCTB Selected Issues* pp. 223 and 234 (n. 72) (D. Weber ed., Kluwer Law International 2012), who calls this the system's "Achilles heel".

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however, provides for a disallowance on exempt share disposals, pursuant to which these assets will be taxed upon a transfer. Where a taxpayer, who, in the current or a previous tax year, has acquired one or more fixed assets that are not depreciated in a pool, leaves a CCCTB group as a result of a disposal of shares in an amount equal to the value of those fixed assets, the transfer will not be exempt. Nonetheless, this rule does not apply if it is shown that there were valid commercial reasons for the intra-group transaction.

Example 5

Using the data from Example 3, assume that, in addition to companies A, B and C, there is a company D, which is an IP company located outside the European Union. The IP company charges the remaining companies 5% of sales (*see* Table 3).

Table 3: Practical example regarding EU versus non-EU operations

Country	Local result (before royalty)	CIT	CCCTB result	CIT
Netherlands (A)	100	25	40	10
Member State B	–60	0	40	10
Member State C	80	20	40	10
Total	120	45	120	30

The tax consequences are as follows:

The IP company charges 5% of sales on the basis of ALP, which results in a gross profit of 6 in Country D (5% × 120). Subsequently, the CCCTB allocation of profits is applied to group companies A, B and C.

6. The Avoidance of Double Taxation Mechanism – An Overview in Light of the CCCTB and OECD Initiatives

6.1. How it works in the European Union

The CCCTB has the primary objective of creating a fair-share taxation system between all EU Member States in order to prevent the kind of arbitrary shifting of profit associated with aggressive tax planning techniques carried out by corporations within the European Union. Employing a three-factor attribution model, it is, by its very nature, intended to supersede existing rules and regulations dealing with similar objectives. Until now, domestic law and international taxation agreements have prevailed with regard to the process of allocating taxing rights to sovereign states.

For domestic law purposes, the Proposed CCTB Directive establishes rules to calculate taxable income across EU tax jurisdictions in order to harmonize the appropriate part of the related tax systems.

With regard to the CCCTB, the situation is completely different, as this proposal goes further in that it provides for a redistribution of taxable income per jurisdiction through the application of consolidation and subsequent formula apportionment of domestic results. Consequently, any income accruing to companies of a consolidated group should follow the rules of the CCCTB. Withholding taxes on various flows between CCCTB Member States will not be levied pursuant to article 10 of the Proposed CCCTB Directive.

Notwithstanding the foregoing, article 9(2) of the Proposed CCCTB Directive provides that "Groups shall apply a consistent and adequately documented method for recording intra-group transactions".

Example 6

Using the data from Example 4, assume that Company A has reported – through another technique – more payroll/employees than company B. The tax consequences of the different definition of payroll and employees results in the data as shown in Table 4.

Table 4: Practical example of CCCTB within the European Union

Country		Member State X	Member State Y
Company A (EU)	Sales	40	
	Payroll and employees	40 (+ 10 = 50)	
	Assets	40	
	Taxable income	30	
Company B (EU)	Sales		80
	Payroll and employees		20
	Assets		20
	Taxable income		60
Tax rate		10%	30%

Company A = (30 + 60) × (1/3 × 40/120 + 1/3 × 50/70 + 1/3 × 40/60) = approximately 51.5 taxable income (as opposed to 50; *see* calculations in Example 4)

Company B = (30 + 60) × (1/3 × 80/120 + 1/3 × 20/60 + 1/3 × 20/60) = 40 taxable income

Therefore, as can be seen from the calculations above, an incorrect or different application of a factor by one of the companies might result in double taxation when applying the CCCTB formula.

6.2. Intercompany transactions with non-EU affiliates: The arm's length principle

Concerning inbound income from non-EU affiliates, the position is completely different. The relationship between CCCTB Member States and non-CCCTB third-party states is governed by the respective tax treaties. However, tax treaty rules on the attribution of taxing rights inevitably conflict with the apportionment formula as outlined by the CCCTB. In order to resolve this situation, several principles have been included in past and present proposals to smooth out possible double taxation.

The two classical methods for the prevention of double taxation are, of course, the exemption and tax credit methods; the main difference between the two being systemic in nature, i.e. the exemption method removes certain income from the tax base whereas the full and

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ordinary credit methods are linked to the tax liability itself. In fact, the rules and stipulations of tax treaties are respected through the CCCTB concept and procedure. With regard to the exemption method, there will be no material change. In respect of income from interest and royalties, however, withholding tax – calculated on a per-country basis – will be shared amongst the CCCTB members according to the apportionment formula. From a technical point of view, such apportionment could create disparities between Member States due to the application of the ordinary credit system (i.e. where the tax rate in the source country is higher than the tax rate in the country allowing a tax credit, the credit is restricted to the domestic tax on the relative foreign-based income) and different nominal tax rates in each Member State. Tax sparing and/or matching credits create additional problems.

The CCTB, being the first stage of the CCCTB, raises various BEPS-related topics that are also applicable in respect of third-country relationships. First, there is a general anti-abuse rule similar to the preceding ATAD provision.

Furthermore, switch-over provisions, which are not applicable if tax treaty protection exists, and CFC rules, which only apply in relation to third-country CFCs, have been introduced, as well as hybrid mismatch rules.

The arm's length principle applies universally to non-EU country business dealings. Corporate entities are deemed to be associated when there is a direct or indirect participation in capital or voting rights, whichever is applicable, of 50% or more. Furthermore, uncertainty remains about the possibility for downward corrective adjustments.

Example 7

Using the data from Example 4, assume that, aside from companies A and B (both located in the European Union), there is a non-EU company C. Under formula apportionment, the CCCTB consolidated profit is allocated as follows:

Company A = (30 + 60) × (1/3 × 40/120 + 1/3 × 40/60 + 1/3 × 40/60) = 50 taxable income

Company B = (30 + 60) × (1/3 × 80/120 + 1/3 × 20/60 + 1/3 × 20/60) = 40 taxable income

The tax burden in Member States X and Y equals 17, i.e. (10% × 50 + 30% × 40), whereas in Country Z it amounts to 10 (25% × 40). This means that the total tax burden of the group equals 27. *See* Table 5.

Table 5: Practical example for avoidance of double taxation regarding intercompany transactions with non-EU affiliates

Country		Member State X	Member State Y	Country Z
Company A (EU)	Sales	40		
	Payroll and employees	40		
	Assets	40		
	Taxable income	30		
Company B (EU)	Sales		80	
	Payroll and employees		20	
	Assets		20	
	Taxable income		60	
Company C (non-EU)[1]	Sales			60
	Payroll and employees			20
	Assets (including intangibles and financial assets)			20
	Taxable income			40
Tax rate		10%	30%	25%

1 Company C only has non-EU activities in Country Z (non-EU). Therefore, it cannot be included in the calculation of the consolidated base.

6.3. The MLI

Concerns might arise regarding the future of dispute resolution mechanisms under the CCCTB proposal. First, the national case law that has developed will lose its ability to provide legal certainty with regard to key concepts of taxation; instead, the ECJ will become the ultimate arbitrator in dispute resolution cases. The efficiency of this development is questionable, as, naturally, tax disputes will not be resolved quickly. Furthermore, this seems to run counter to the recognition of the European Union and OECD, under the proposed Dispute Resolution Directive[19] and the OECD Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI),[20] of the importance for taxpayers to have recourse to timely, effective and efficient dispute resolution. It is also likely that the application of formulary apportionment under the CCCTB will lead to an increasing number of cases where dispute resolution is needed, which would also cause delays under such a centralized system.

It can, therefore, be concluded that the application of the CCCTB, in terms of dispute resolution, would only work if it were aligned with and integrated into the MLI proposal of the OECD, allowing states to make reservations respecting their own political, legal and economic situations, as common dispute resolution rules should still observe the different needs and speeds of integration of countries.

19. European Commission, Proposal for a Council Directive on Double Taxation Dispute Resolution Mechanisms in the European Union, COM(2016) 686 final (25 Oct. 2016), EU Law IBFD.
20. *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (24 Nov. 2016), Treaties IBFD, signed in Paris on 7 June 2017.

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Table 6: Differences between the CCCTB proposal and Dutch domestic law		
	CCCTB proposal	**Domestic tax law (the Netherlands)**
PE rule	No such provision; all PEs located in the European Union are be included in the consolidation based on article 6(1)(a) and 6(b) of the Proposed CCCTB Directive.	A PE must be equipped with sufficient facilities to operate as an independent business and be able to supply goods or services to third parties.
CFC rules	A parent company has decisive influence over a foreign subsidiary if it holds a direct or indirect participation of more than 50% of the voting rights, owns directly or indirectly more than 50% of the capital of the foreign company, or is entitled to more than 50% of the profits of that company. The tax rate of the CFC must be lower than that of the parent company.	There are no CFC rules in the Netherlands, however, it is mandatory to reassess shareholdings of 25% or more in low-taxed companies whose assets consist of a minimum of 90% "passive" assets.
The hybrid mismatch rules	The source state should deny a deduction if a payment is not taxed in the residence state. If the payment originates in a third country, the Member State of the recipient must include the income in the tax base, unless that state has denied the deduction.	Income arising from hybrid instruments is excluded from the applicability of the participation exemption, i.e. source state qualification is followed.
Switch-over	It does not allow for an exemption of foreign income received from an entity in a third country if the CIT rate of that country is less than 50% of the statutory rate of the Member State concerned.	The application of the participation exemption to foreign income in the Netherlands is not limited to half of its statutory rate.
Interest barrier	Limits at the level of the group the annual deduction of net borrowing costs to the greater of (i) 30% of earnings before interest, taxes, depreciation and amortization (EBITDA) and (ii) EUR 5 million.	An implementation proposal limits the deduction of net borrowing costs to the greater of (i) 30% of earnings before interest, taxes, depreciation and amortization (EBITDA) and (ii) EUR 3 million.
Exit taxation	If assets are disposed of within three years after the economic owner of the assets departs from the group they are included in the tax base.	The fair market value of the assets minus the book value is considered a taxable capital gain (*see* chapter 9 of the OECD Transfer Pricing Guidelines).

7. Conversion and Alignment Aspects

7.1. CCCTB versus domestic tax laws and regulations

Article 1(1) of the Proposed CCTB and CCCTB Directives states that companies applying the Directive are no longer subject to national corporate tax law in respect of all matters regulated by the proposals, unless expressly indicated in the proposals. An important exclusion concerns shipping companies benefitting from the tonnage tax regime. Shipping companies are, however, taken into account in determining which companies belong to the same group.

Under the Proposed CCTB Directive, many domestic provisions will remain applicable, for instance, the provisions on tax rates because no consolidation takes places. This would mean that the CCTB will not result in a level playing field, which is one of the cornerstones of eliminating harmful tax competition. Furthermore, transfer pricing issues and loss-relief problems will remain.

Another question that arises is whether domestic consolidation rules can be applied alongside the CCTB.

In order to reduce the need for national legislation and legal practice, the 2011 proposal[21] contained a provision on general tax principles for calculating the tax base, including the realization principle, the idea that transactions and taxable events should be measured individually, the need for consistency in the calculation of the tax base and the concept that the tax base should be determined for each tax year (article 9 of the 2011 Proposal). This provision was motivated by the fact that the CCCTB does not provide for harmonization of accounting principles. Under the current proposal, however, this provision is no longer included, as the use of domestic accounting principles could result in huge accounting discrepancies. In order to achieve a common tax base for tax purposes, substantial compliance costs would be required, as numerous fiscal conversions would be necessary.

7.2. Matrix of the CCCTB base of calculation and how it differs from a domestic tax return

The matrix shown in Table 6 illustrates some of the main differences between the CCCTB and domestic tax law (the Netherlands is used as an example) with regard to the measures discussed in section 4.

8. Combining the CCCTB and the Arm's Length Principle: A Full Value Chain Analysis as the Linchpin

8.1. The CCCTB and a value chain analysis

The CCTB and CCCTB proposals should preferably be aligned with the concept of value creation. This would also

21. Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121 final (16 Mar. 2011).

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avoid any major disruptions to the EU internal market. The proposals should also take into account functions, assets and risks, as these are the indicators of the real substance of a company and its operations. The authors believe that a value chain analysis can be used as a bridge between the arm's length principle and the CCCTB.

8.2. The arm's length principle and a value chain analysis

The pie chart in Diagram 1 divides an MNE's assets and activities into three categories: (A) managing fixed/tangible assets, (B) managing intangible assets and (C) non-intangible premiums, such as "location savings", "assembled workforce", and "synergies".[22] This approach allocates the overall results of an MNE, where each entity has control over a certain category of assets and/or performs certain activities. The respective slices of A, B and C will be reported in the tax return of the taxpayer entity. In addition, intercompany transactions are reflected in the entity's Master File (MF), Local File (LF), Local transfer pricing forms etc., and will have to support the slices of A, B and C as reported in the corporate income tax return.

In summary, Diagram 1 visualizes the relationship between a holistic perspective of a value chain analysis (slicing the pie) and the set of intercompany transactions that determines domestic taxable income. Under the BEPS Project, all of these perspectives should be 100% synchronized.

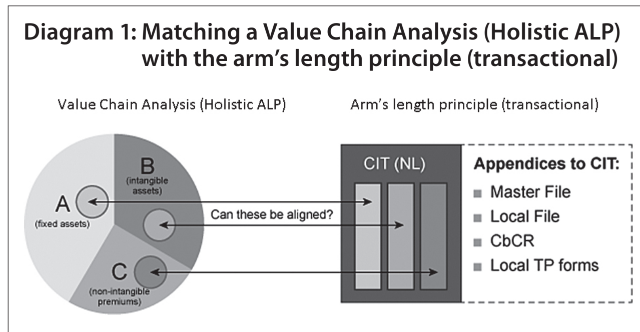
8.3. VCA support in slicing the pie versus CCCTB manner of slicing the pie

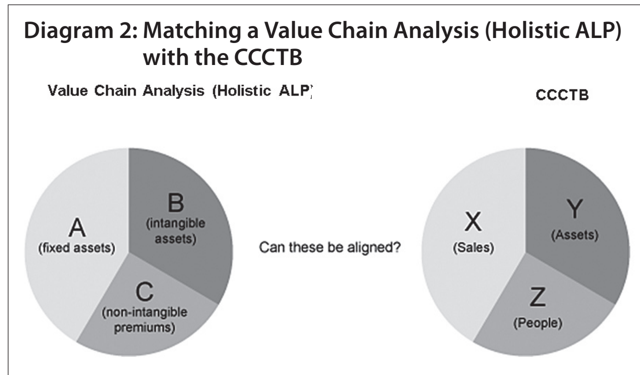
Section 8.2. explained how a holistic perspective on value chain gets translated into the transactional approach taken by the arm's length principle. Diagram 2 shows the relationship between a holistic perspective on value chain and the three allocation factors used under the CCCTB.

It can be seen from Diagram 2 that:
– Category A (fixed assets), from a holistic perspective, can easily be linked to the Y factor (assets) from the CCCTB chart;
– Category C (non-intangible premiums, such as embedded workforce) can be connected with the Z factor (people);
– the problem arises with Category B (intangible assets), as it can only match with the X factor (sales) to the extent that the return on investment/royalty income is allocated to the group entities engaged in sales proportionally to third-party sales, as illustrated in the examples below.

Example 8

We have three entities in different Member States (Company A, Company B and Company C) (*see* Diagram 3). Each of the companies has 1/3 of the sales. If only one company is performing DEMPE functions (development, enhancement, maintenance, protection and exploration of intangibles), the value chain analysis will not match the CCCTB, which means that the CCCTB will





not allocate the profits accurately from an economic perspective. This will result in a misalignment, which will not reflect the real value creation using the CCCTB factors. Such misalignments not only constitute a distortion of economic principles, but also infringe the four fundamental freedoms of the internal market protected by the TFEU.

9. Conclusion

The following can be concluded:
– the CCCTB would create a complex concept for taxation in Europe;
– a reconciliation between domestic tax books and the IFRS standard would result in significant additional compliance costs and effort by MNEs;
– the CCCTB needs to revise article 9 of tax treaties, since the arm's length principle will nevertheless remain applicable to intercompany transactions involving non-EU entities and/or activities;
– the CCCTB seems to deviate from economic substance in many instances, which results, inter alia, in a disruption of FDI flows in the European Union, or taxation of income in Member States where the value creation does not happen;
– the CCCTB does not eliminate tax competition between Member States, nor does it effectively eliminate the issue of double taxation in the European Union; and
– the CCCTB could only replace the arm's length principle to the extent that it is aligned with a holistic value chain perspective, such that the three-factor formula better reflects economic substance.

22. As discussed in sec. 5.1.1.

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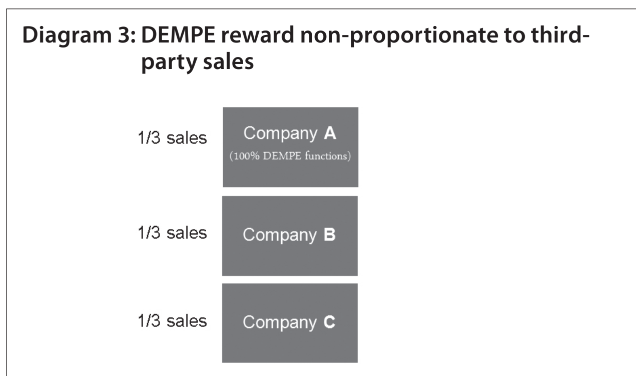

Diagram 3: DEMPE reward non-proportionate to third-party sales

Example 9

In the scenario shown in Diagram 4, however, if DEMPE functions were to be distributed evenly amongst the CCCTB consolidated companies, then the value added chain would potentially match the CCCTB. Nevertheless, it has to be borne in mind that the latter scenario is unlikely.

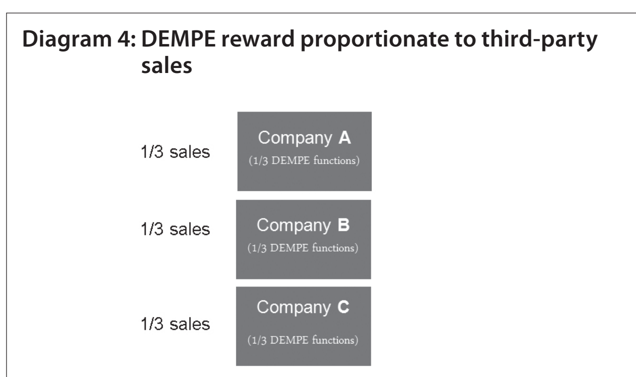

Diagram 4: DEMPE reward proportionate to third-party sales

Appendix 1: European Commission Perspective

1. In general

Contrary to some of the Member States' objections, the European Commission relies on various unconvincing arguments to justify the CCTB and CCCTB, which are summarized below.

1.1. Principle of proportionality

Contrary to some Member States' objections, the Commission sees the application of the CCTB and the CCCTB as justifiable on the grounds of the principle of proportionality. The Commission states that the proposed measures are both suitable and necessary to achieving the objectives. Here, the Commission focuses first on the CCTB proposal when arguing that it does not go further than harmonizing the corporate tax base, which is necessary to prevent the identified business obstacles to the internal market. The Commission goes on to make arguments regarding the complete CCCTB package, stating that it does not restrict the Member States' sovereignty to determine their desired amount of tax revenue in order to meet their budgetary policy targets, since the CCCTB package does not affect the Member States' right to set their own tax rates. Furthermore, the it argues that mere coordination between the Member States would not suffice since tax coordination measures mostly target specific issues and cannot resolve the identified issues regarding the internal market, which instead require a holistic solution. Another argument regarding compliance with the principle of proportionality is that the CCCTB package would only be mandatory for a certain category of taxpayers, namely groups of companies that exceed a certain size.

1.2. Principle of subsidiarity

Likewise, contrary to some Member States' objections, the Commission sees the application of the CCTB and the CCCTB as justifiable also on the grounds of the principle of subsidiarity. The Commission argues that even though the issues tackled by the CCCTB package have distinct origins, they can only be tackled effectively through a common solution at an EU level. The alternative, forcing the Member States to take action separately, would perpetuate, or even worsen, the current situation, as businesses would still have to deal with 28 different tax systems. The CCCTB package aims to increase job growth throughout the internal market and prohibit aggressive tax planning. Since these objectives are of a multinational nature, the most efficient measure to implement them would be a common one. Otherwise, the field of corporate taxation would remain fragmented, allowing present fiscal obstacles and unfair tax competition practices to continue to exist. In fact, the Commission argues that most key features of the CCCTB package can only be achieved through collective action at the EU level, such as issues of double taxation, double non-taxation, cross-border loss relief and intra-group transfer pricing.

1.3. Free movement of capital

As Pereira (2014) states:[23]

> Of course, with regard to third country companies, only the freedom of capital movement could be challenged. It is noteworthy, however, that the Court has recognised the use of the arm's length standard in order to determine abuse. Moreover, one may argue that thin capitalisation rules based on the debt and equity ratio could infringe the non-discrimination clause contained in Member States' DTCs with third countries.

In light of ECJ case law, a fixed debt to equity ratio would be contrary to the fundamental freedoms.

The arguments against the introduction of the CCTB and CCTB include the following:
(1) countries will be tempted to lower their tax rates (leading to competition; the opposite of what they want to accomplish);
(2) some countries argue that there is no legal basis for such a proposal; article 115 of the TFEU, as a whole, makes no provision for measures in the area of direct taxation. They also emphasize that Member State sovereignty prevails in respect of direct taxation;
(3) in particular, the Netherlands has mentioned that the introduction of the CCCTB would have a negative impact on GDP in the European Union as a whole;
(4) the Netherlands has also mentioned that the proposed basis of apportionment for common (cross-border) consolidated profits works against Member States

23. T.A. Pereira, *International Aspects of the CCCTB in Europe*, available at https://cris.maastrichtuniversity.nl/portal/files/1670646/guid-a64ea355-e7ad-4393-acb9-6010980cd6eb-ASSET1.0.

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with a large service industry because factors, like intangible and financial assets, are not included in the apportionment model. The Netherlands, amongst others, would be put at a disproportionate disadvantage;
(5) the CCCTB will redistribute wealth between Member States such that there will be a transfer of wealth from relatively poor developing EU economies to much more developed and richer EU economies; and
(6) it rewards economies that are still dependent on old labour-intensive economic sectors and penalizes those where productivity is relatively high and/or that have moved to higher value-added economic activities and/or where market size is limited.

Nonetheless, the Commission is of the opinion that the CCTB – followed by a CCCTB – is a positive step forward, as it believes that a common corporate tax base provides for a single set of EU rules to decide how much of a company's profit will be taxed, once various exemptions and income deductions have been accounted for.

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015TRP-A01-H

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