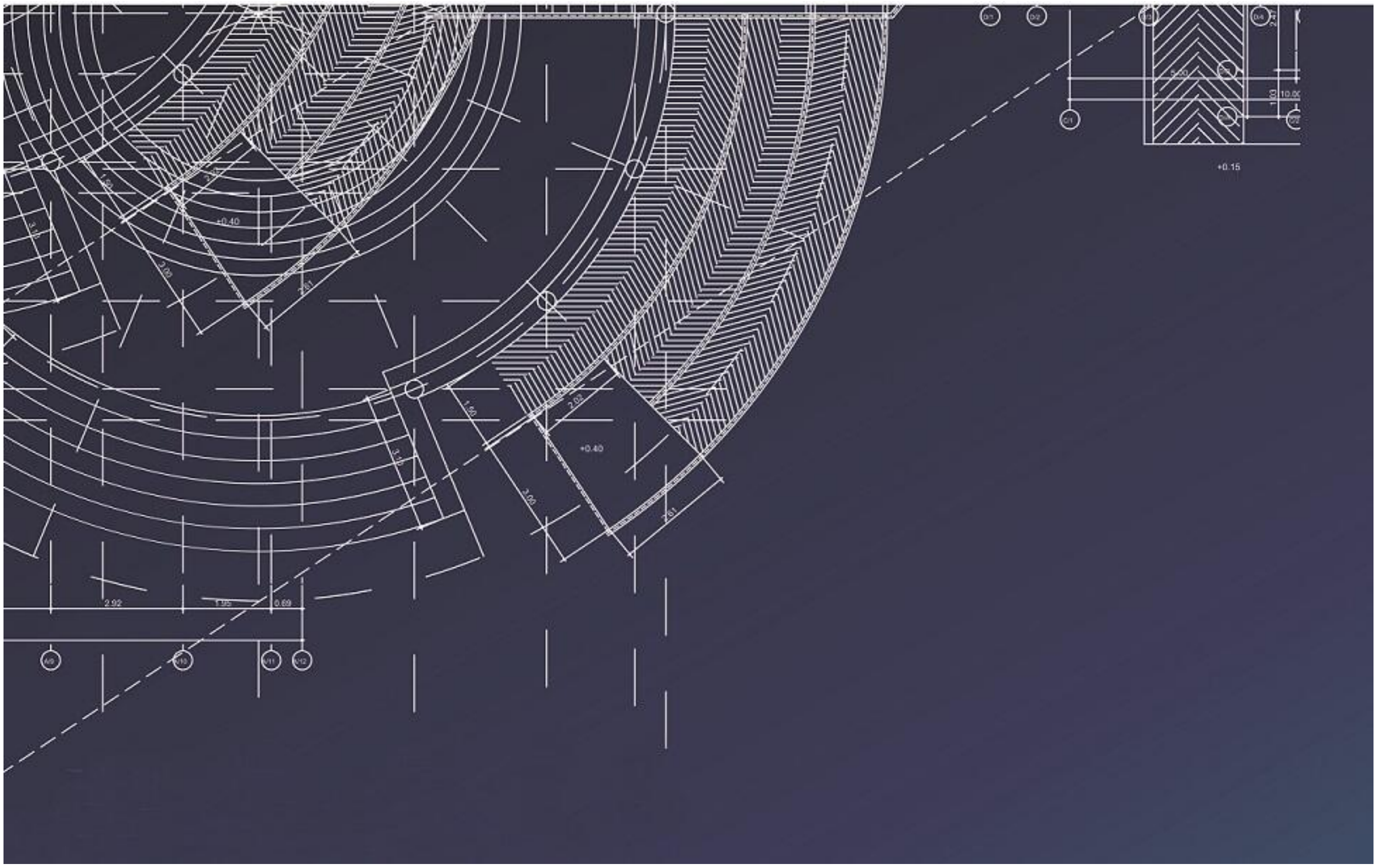
Adjusting the masterplan

International Tax Large Corporate



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Bill Dodwell considers the latest proposal for a CCCTB

One of the great desires of the European Commission is to take control over corporate taxes across the European Union. This plan does not involve allocating the revenues to Brussels, but it does involve member states agreeing to give up most national control over corporate taxation.

The first iteration of this masterplan for a Common Consolidated Corporate Tax Base (CCCTB) came in 2011. The basic idea is that the total profits and losses of a multinational group operating within the EU should be added up, using the same accounting and tax base, and then allocated to individual countries based on a pre-determined formula. The formula favoured by the Commission is to split the profit (or loss) into three and allocate it to individual countries based on the location of destination sales, employees (with the subtlety of doing this both by numbers and by payroll costs), and tangible assets. It’s very much a formula based on Victorian manufacturing.

Since the member states didn’t like the original plan, it has now been split into two stages. The first involves the member states adopting a common tax base and, once this dubious milestone has been achieved, move on to consolidation as well. The result is that the Commission has released two draft directives for member states to mull over.

There are a few changes from Plan A in the common tax base. The first is that adoption of the new system should be compulsory for groups with consolidated turnover of €750 million or more. This makes sense: offering companies a choice is simply offering a free bet against the Exchequer. There’s a full participation exemption, such that dividends and capital gains from 10% or greater shareholdings are exempt.

Something new for 2016 is a proposal for a super-deduction for R&D costs. There’s a 50% uplift for costs up to €20 million and a 25% uplift above this threshold. Various EU states invest substantially in tax relief for R&D, with French tax credits worth over €5 billion annually.

The introduction to the draft directive says that the Commission wants to tackle the ‘debt bias’, which apparently arises as tax relief is given for interest but not for dividends. The analysis doesn’t consider what happens to the recipients of interest or dividends. Even though it is sometimes hard to trace ultimate recipients, the likelihood is that interest is taxed more heavily than dividends. The CCCTB thus proposes adopting the same interest limitation rules adopted in the Anti-Tax Avoidance Directive. This means that interest deductions are limited to 30% of earnings before interest, tax and depreciation (EBITDA), with exemptions for standalone companies and groups where total interest is less than €3 million.

The surprise is the ‘allowance for growth and investment’. This is a tax deduction or taxable amount based on the bond yield applied to the annual increase or decrease in capital and reserves. Shares in subsidiaries are excluded from the definition, so that the allowance is focussed on the growth in the standalone company’s business.

The directive provides for basic accounting to be adopted – rather than the valuation approach of IFRS. It states ‘Revenues shall accrue at the moment that the right to receive them has arisen and they can be measured reliably, irrespective of whether the relevant amounts have actually been paid.’ Expenses are treated in a similar way and there a short list of rules to specify which expenses are not deductible for tax purposes, such as 50% of entertaining costs. There’s an exception to basic accounting for financial assets or liabilities held for trading, which are valued at market value, but most of the IFRS complexity is ignored. This is sensible – the UK tax system allows IFRS adjustments to be excluded from taxable profits on the basis that tax should only be levied on realised profits.

The proposal for consolidation is unchanged from 2011. Allocating profits to countries based on the location of the group’s employees, tangible assets and destination sales ignores intangible assets. Intangible assets are now a major part of modern businesses and ignoring their existence doesn’t give a realistic way of allocating profits to where economic value is created. Germany – where intangible assets are a major part of its engineering sector – is reportedly against the consolidation aspects. This is presumably on the basis that profits arising from German research programmes could be allocated to overseas manufacturing plants which benefit from, but do not create, the assets.

The allocation factors also won’t work for smaller economies which might manufacture goods or provide services to other countries. The destination sales factor will automatically allocate profits away from the activity that creates them to the larger countries with many more customers.

There’s also no plan for transactions with countries outside the unitary zone, which will want to adopt the usual arm’s length pricing rules.

Undoubtedly the European Commission will try even harder to persuade the member states to adopt its new plans. The issue for governments is whether it makes economic sense to give up control of one of their top five taxes.