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# Corporate income tax in the EU, the Common Consolidated Corporate Tax Base (CCCTB) and beyond: is it the right way to go?

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**Working Paper 2018.06**

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**europaean trade union institute**

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## Introduction

Corporate income tax (CIT) has been a subject of much debate for many years. The main issues are tax competition, the low effective tax rates faced by multinational enterprises (MNEs), the spread of preferential regimes and, more recently, the consequences of digitalisation of the economy. Some of these issues are not new. Tax competition has been a matter of debate for quite some time. The issue of preferential tax regimes was at the core of the Monti package<sup>1</sup> that was proposed by the European Commission in the mid-1990s and resulted in the adoption of the ‘Code of Conduct’ and of the first version of the Savings Directive at the turn of the century. In 2011, the Commission made a first proposal for a Common Consolidated Corporate Tax Base (CCCTB)<sup>2</sup>. The debate never went further than a technical discussion, and the proposal was set aside, the Council and the Commission considering that there was no political consensus.

The European Commission has recently made a new proposal<sup>3</sup> in the context of a renewed tax policy debate. The new proposal differs from the previous one in several key aspects: (1) it is a two-step approach, with a Common Corporate Tax Base (CCTB) at the first stage and consolidation with formula apportionment at the second stage; (2) the CCTB would be mandatory for large firms and remain optional for others; and (3) the proposal includes an Allowance for Growth and Investment and a Super-Deduction for R&D.

The momentum has also to be considered. The issue of low effective tax rates paid by MNEs has resulted in strong political pressure. In 2013, the OECD and the G20 initiated the BEPS (Base Erosion and Profit Shifting) Project<sup>4</sup>, and, within two years, they had reached a comprehensive political agreement covering the most relevant issues. Most are still awaiting implementation, but the process is under way, and the geographical coverage has been expanding, with more than 100 countries now members of the ‘inclusive framework’ that is monitoring the process. At EU level, the Anti-Tax Avoidance Directive (ATAD), which formalises some of the BEPS recommendations, was adopted in an incredibly short period of time: the proposal was made in January 2016, and a political agreement was reached at the end of June 2016<sup>5</sup>.

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1. See Hinnekens (1997) for a discussion of the proposal.

2. See European Commission (2011).

3. European Commission (2016a).

4. OECD (2013).

5. European Commission (2016b). Amendments supplementing the original proposal were put forward and adopted within a few months. See Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries.

This working paper aims to review the key elements of the debate at European level without entering into a technical discussion of the Directive, article by article. We start with a discussion of the main issues, including BEPS, and their implications for tax policy. We then turn to the CCTB proposal. After a brief presentation of the main characteristics of the proposed CCTB, we discuss the relevance of the proposal and to what extent it could provide a comprehensive solution for the main issues at stake.

## Main issues in corporate taxation

Globalisation is now a widespread phenomenon. In the EU, the process was initiated with the single market. The removal of barriers and the harmonisation of regulations have made tax differences more visible and magnified their effects. Key decisions of firms, including the location of economic activities and the location of taxable profits, are increasingly tax-sensitive. A product may be sold in country X after having been manufactured along a value chain that may be spread around the world. The location of the various steps of the value chain may be sensitive to taxes.

An increasing number of international transactions now occur between affiliates of an MNE and are thus not 'market-priced'. This holds not only for intermediate goods, but also for royalty payments, services, interest on debt. For each of these transactions, MNEs have to set a 'price' (including the level of the royalty or the interest rate charged on intra-group debt). The basic rule in international taxation is the 'arm's-length principle', according to which the price for any transaction between related parties has to be set at the same level as would apply if the transaction had taken place between unrelated parties. Transfer pricing audits relied historically on 'comparable transactions'. However, over time, the nature of the transactions has been evolving, moving from intermediate goods to intangibles. Some transactions also include a return for 'exposure to risk'. There is a whole army of tax lawyers focusing on transfer-pricing strategies. A significant proportion of these strategies aim to minimise the CIT liability of the group and therefore have a huge impact on the location of taxable profits.

This makes the location of taxable profits highly sensitive to taxes. The main motivation for the BEPS project was to tackle the discrepancy between the location of value creation and the location of taxable profits.

Digitalisation exacerbates the process (OECD 2018). Some businesses may engage in significant economic activity in a given jurisdiction without having a taxable presence ('scale without mass'). The concept of permanent establishment seems obsolete. Digitalised firms rely heavily on intangibles, which enables them to exploit profit-shifting strategies through the location of patents in low-tax jurisdictions and non-arm's-length pricing of royalties.

In most of the EU countries, the CIT base is highly concentrated in a relatively small number of firms, and most of these firms are affiliates of MNEs. This makes CIT revenue more sensitive to profit-shifting strategies of MNEs.

## **The BEPS initiative and its implementation**

Globalisation and digitalisation of economies have put pressure on the tax system. The basic rules for international taxation, which originate from roughly a century ago, seem out of date. Those rules have two main components: tax treaties and transfer pricing guidelines.

Tax treaties rely on the basic concepts of ‘source’ and ‘residence’, which are used to determine the country in which income has to be taxed. Another key concept is ‘permanent establishment’. These concepts are challenged by value chains that spread production and distribution of a given good or service over a large number of countries. The ‘permanent establishment’ concept is challenged by digitalisation: it relies on physical presence, whereas digitalisation enables MNEs to make a profit in a given country without having any physical presence.

A tax treaty network has been built over time: for many decades, countries have been negotiating with their partners on a bilateral and case-by-case basis to prevent double taxation. Most of the bilateral treaties rely on the OECD or UN model, which ensures consistency. But two main issues remain: the policy goal was to prevent double taxation, while the issue is now double non-taxation, and the need for a multilateral instrument has not been recognised.

The OECD transfer pricing rules are the second main component of the international tax system. As explained above, they are based on the arm’s-length principle. Firms now rely heavily on intangibles (patents, trademarks). This puts pressure on transfer pricing rules. Applying the arm’s-length principle for a component of a car or for raw materials is quite straightforward, but what is the ‘comparable’ for royalties? A patent is unique by nature. And how should trademarks or exposure to risk be priced?

MNEs are therefore able to use the rules to shift profits from high-tax locations to low-tax jurisdictions. An illustration of this was the case, widely reported in the media, of the lasagne which, instead of containing beef, had been fraudulently made with horsemeat. The second, and unnoticed, scandal with regard to this case was the route taken by the value added and profits, passing through Luxembourg, Cyprus and the Netherlands, where – undoubtedly – nothing was cooked or packed. However, a significant proportion of the profits was registered in those countries.

The three main instruments for profit shifting are transfer pricing, debt shifting and royalty payments. Transactions between affiliates are priced so that expenses are charged on profits located in high-tax countries, with the corresponding revenue accruing in low-tax countries. Entities located in

high-tax countries are financed mostly by debt funded by financial companies that are members of the group and enjoy low tax rates on interest income. Royalties accrue to an affiliate that holds the patents of the group and is located in a tax haven, or in a non-tax haven country that offers a preferential regime for income from patents. MNEs also exploit the mismatch resulting from inconsistencies in rules between countries ('hybrids'). An example is a payment that is recognised as interest in country X and as a dividend in country Y: the tax rules make it deductible in country X, with no taxation in country Y.

The BEPS action plan included 15 actions (OECD 2013). Most of the issues relating to profit shifting were addressed, but tax incentives for real economic activities remained out of scope. It focused on counteracting profit shifting, not on counteracting tax competition. And even if the stated goal was to reconcile the payment of taxes with the location of value added, it neither explored nor mentioned the alternative of formula apportionment<sup>6</sup>.

A broad political agreement was achieved in two years, but most remains to be done in the implementation phase, which is still going on and will continue for at least a couple of years. The political agreement included minimum standards, reinforcement of other standards and recommendations for common approaches and best practices.

The strongest part of the agreement consists of minimum standards. They apply first of all to some harmful tax practices. There is a 'substance' requirement for patent box regimes and holding regimes. A preferential tax regime may be granted for patents and royalties only in relation to real research activity being conducted in the country (see below). Substance requirements also apply to holding companies. The minimum standard also imposes the exchange of rulings. Another minimum standard aims to counter treaty abuse. In the same vein, country-by-country reporting is mandatory – but not public – for MNEs for which the consolidated revenue exceeds €750 million.

The second branch of the agreement aims to reinforce existing standards. Transfer pricing guidelines are to be reviewed, with a special focus on intangibles, financial transactions and financial flows that price exposure to risk. Some of the basic provisions of the OECD model for tax treaties are also to be revisited to avoid treaty shopping and artificial use of tax treaties.

The third branch of the agreement includes recommendations and suggestions for best practices. As regards hybrids, it includes recommendations to prevent deduction without symmetric taxation in the hands of the beneficiary. As regards interest deduction, the recommendation is to limit this to a percentage of the gross operating surplus (earnings before interest, tax, depreciation

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6. 'Formula apportionment' refers to a method that splits the taxable basis of a company or of a group according to the location of assets, payroll, sales, etc. It is used by federal countries that have to split the tax base between sub-national governments (US states, Canadian provinces). The CCTB aims to apply it at EU level in its second phase. (See below.)

and amortisation, EBITDA). At EU level, both of these have been translated into directives (ATAD 2 for hybrids and ATAD 1 for interest deduction), so that binding rules have been put in place, which clearly goes further than recommendations or suggestions for best practices.

Finally, participating countries agreed on setting up a multilateral tax agreement, overriding tax treaties. This means that, once a country has signed up to a given recommendation, tax treaties are automatically adapted and do not have to be renegotiated one by one.

Reaching such a broad agreement in the space of two years with broad geographical coverage is certainly impressive. Does this mean that ‘playtime is over’? There is still ongoing implementation work, and the devil may be in the detail. It could also be objected that the most radical way to address the base erosion and profit shifting issue was to move from separate taxation of MNE affiliates to consolidation and formula apportionment, but, as indicated above, this approach was rejected at an early stage of the project. The alternative view may be that the BEPS agreement is the final attempt to revive the core rules of international taxation and that, in the case of failure, the route of consolidation and formula apportionment will be the only way to go.

## **Nominal tax rates: is there a race to the bottom?**

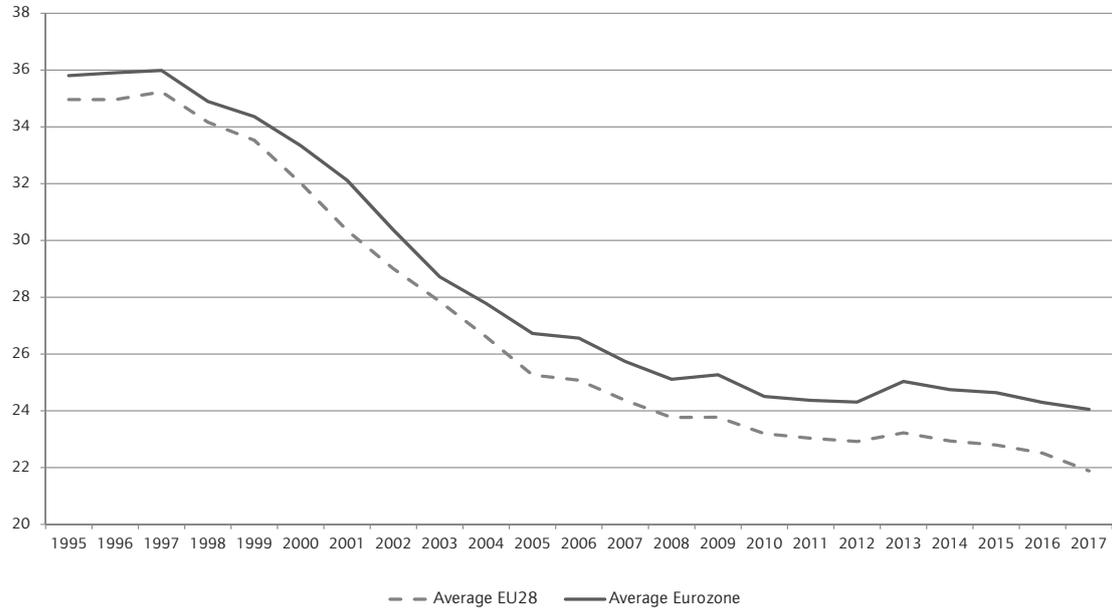
One of the main concerns in corporate taxation is the ‘race to the bottom’. Nominal tax rates have been lowered over time. In 2017, the average CIT nominal tax rate was 21.8% for EU28 and 23.3% for the eurozone, while it was close to 35% in 1995 (see Figure 1).

But does this mean that there is a race to the bottom? This requires a ‘downward convergence’, which means a decrease in the average and a decrease in dispersion. Figure 2 illustrates that this is not the case: while the average has decreased over time, dispersion has been increasing over time, and this holds for the EU as a whole and for the eurozone as well.

As may be seen from Figure 1, most of the decrease took place between the turn of the century and the financial and economic crisis. A closer look at what happened during this period indicates that most of the decrease occurred in Central and Eastern Europe (see Figure 3 for New Member States (NMS) and Figure 4 for countries of Western Europe). Some Western Member States that were geographically close to Central and Eastern Europe were ‘contaminated’, but the EU as a whole was not (Valenduc 2008). This has resulted in increased dispersion of the nominal tax rate, as indicated by Figure 2.

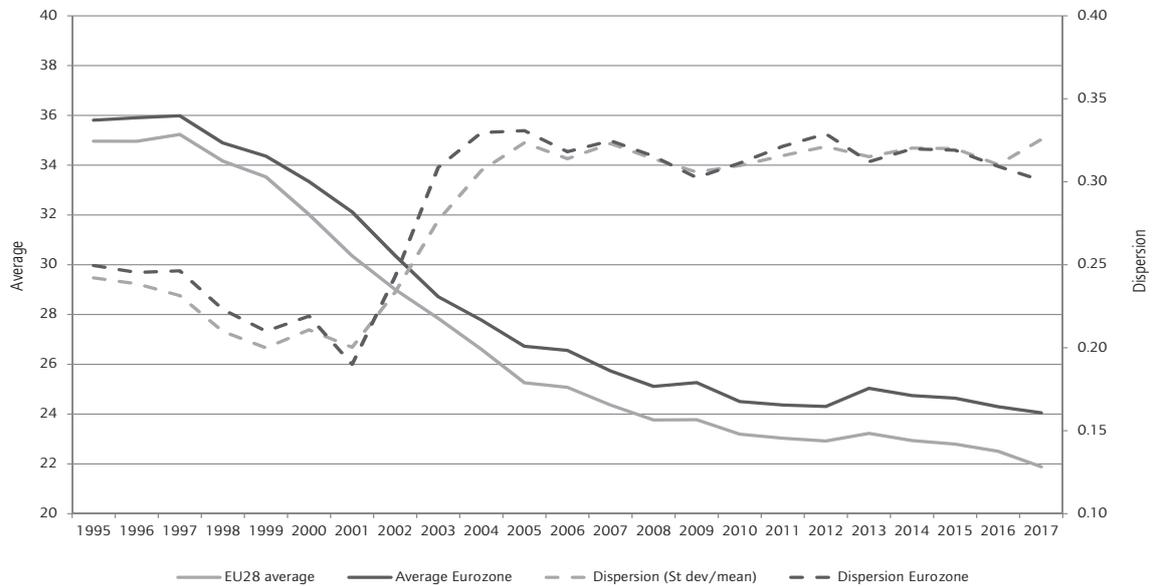
The dispersion in nominal tax rates increases the incentive for profit shifting. Let us consider, for example, a transfer pricing strategy. What matters is the difference in nominal tax rates between countries. The greater the difference (more generally, the dispersion), the stronger is the incentive for profit shifting.

Figure 1 Nominal CIT rates



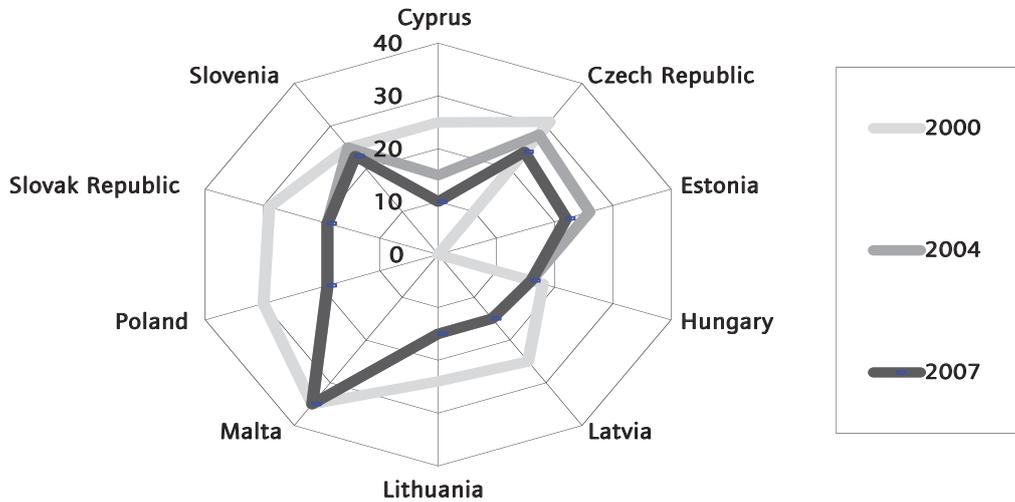
Source: European Commission (2018) – own calculations.

Figure 2 A race to the bottom? Average and dispersion of CIT rates



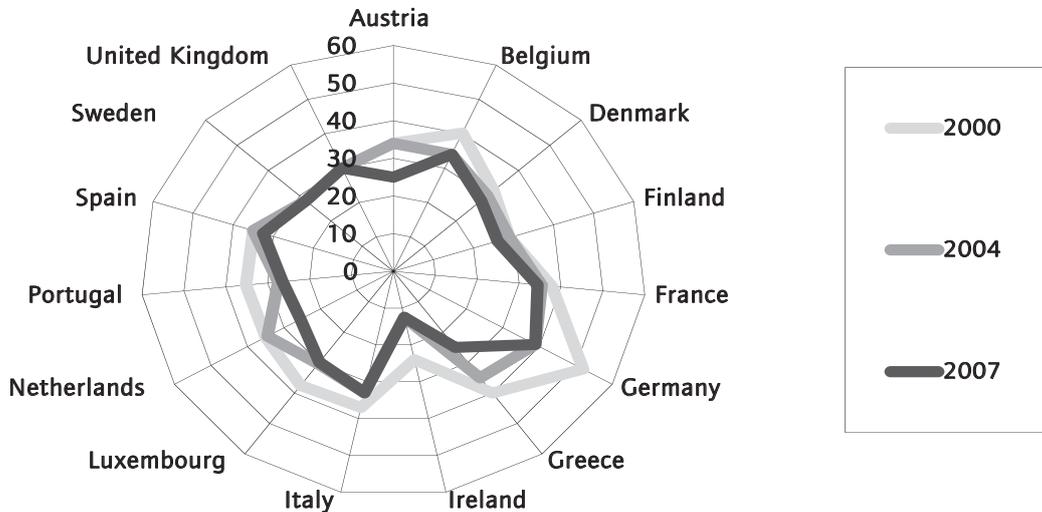
Source: European Commission (2018) – own calculations.

Figure 3 CIT rates in New Members States



Source: European Commission 2008.

Figure 4 CIT rates, EU 15



Source: European Commission 2008.

## What about effective tax rates?

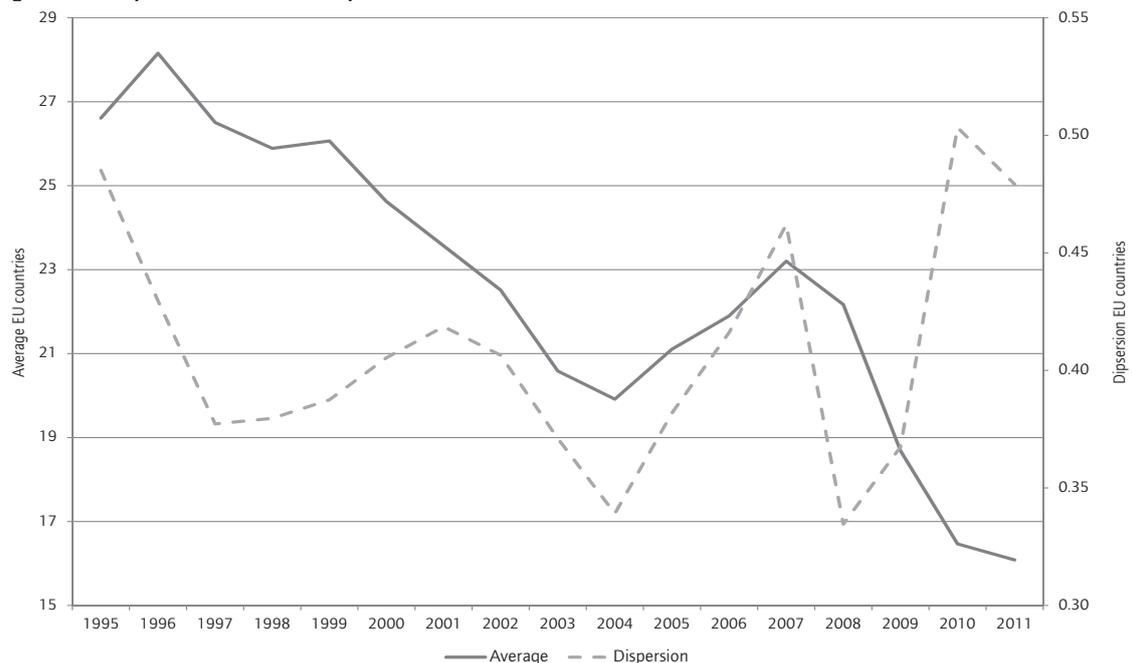
Nominal tax rates have high visibility, they reflect policy decisions and they are the main determinant of profit shifting. However, they do not reflect tax effectively paid by companies. To measure this, it is necessary to use effective tax rates. There are various types of effective tax rate, and they can be grouped into *ex ante* indicators and *ex post* indicators.

A first type of effective tax rate (ETR) is derived by modelling the effect of corporate income tax on the cost of capital. These ETRs are *ex ante* calculations that take into account only some of the parameters of the basic tax system<sup>7</sup>. They are found in the literature as the ‘marginal effective tax rate’ (METR) for an investment earning only the normal rate of return<sup>8</sup> and as the ‘average effective tax rate’ for an investment earning a higher rate of return. The annual Taxation Trends Report (European Commission 2018) includes a table showing such effective tax rates. These effective tax rates are stylised forward-looking indicators.

Implicit tax rates, on the other hand, are *ex post* indicators and are based on CIT paid and on a proxy of the corporate income tax base<sup>9</sup> that is taken from the national accounts. They systematically take into account tax credits and provisions that reduce the tax base.

Figure 5 displays the average and dispersion of the implicit tax rate on corporations over the 1995-2011 period. There was a race to the bottom up to 2004, but the situation is unclear for the rest of the period.

Figure 5 Implicit tax rate on corporations



Source: European Commission (2018) – own calculations.

7. They usually take into account nominal tax rates, depreciation rules, general tax incentives and the tax treatment of interest, dividends and capital gains at company level and, in some cases, at shareholder (or loan provider) level.
8. The normal rate of return is usually equated to the interest rate for long-term government bonds.
9. The proxy of the tax base should be the sum of net operating surplus and of net property income, excluding dividends.

Implicit tax rates are, however, biased by profit shifting: national accounts record profits, and, unfortunately, there is no other option than to record manipulated profit. The only way to circumvent such bias is to relate CIT paid to an element that is not affected by tax planning, such as payroll or fixed assets. Such an approach was followed by the OECD in its evaluation of the impact of BEPS on CIT revenue (OECD 2015a), and, more recently, by Torslov, Wier and Zucman (2018). None of these sources, however, provides trends for such effective tax rates: they merely give estimates for a given year.

## **The spread of preferential tax regimes**

Tax competition does not come about only through tax rates. It may also occur as a result of favourable base provisions or specific rates that create ‘niche regimes’. This second way of competing is less costly for governments, since they need only cut the rate on a small part of their tax base.

The issue is not new. Preferential tax regimes were at the heart of the discussion of the Monti package in the 1990s and were one of the core issues in the contemporaneous OECD debate (OECD 1998). This resulted in a Code of Conduct at EU level and in the coordinated dismantling of most of the preferential tax regimes on mobile activities. The same occurred at OECD level, under the initiative on countering harmful tax practices.

The intention of both tax policy initiatives was, of course, to curb tax competition, but the result is debatable. An interesting modelling exercise pointed to some doubts (Diaw and Gorter 2002): ‘The Code of Conduct for business taxation may, diametrically opposed to its intention, aggravate tax competition between EU Member States. The reason is that it induces, by restricting harmful tax practices, cuts in generic tax rates that may reduce tax revenue even further. (...). We show within a standard tax competition framework that this scenario is more likely to unfold with a higher upper bound for non-distortionary taxes, a higher responsiveness of mobile capital to tax rate differentials, and a smaller endowment of internationally mobile capital.’ We stated above that most of the downward trend in nominal tax rates occurred at the turn of the century, just after the adoption of the Code of Conduct. The downward trend was concentrated in countries of Central and Eastern Europe, which, having to comply with the Code of Conduct, used nominal tax rates to engage in tax competition.

A second wave of preferential tax regimes occurred in the next (and current) decade, with the ‘patent box’ regimes that allow a low effective tax rate for profits arising from the use of patents<sup>10</sup>.

These preferential tax regimes were at the core of the BEPS action plan. The outcome is the ‘nexus approach’ that aims to restore a linkage between R&D expenditures and exemption of profits arising from patents (OECD 2015b).

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<sup>10</sup>. See Evers *et al.* (2015) for a description and discussion of the main tax policy issues.

According to the ‘nexus rule’, income arising from intellectual property is eligible for favourable tax treatment only up to a ratio  $R$ , which relates the sum of R&D expenditures incurred by the taxpayer itself and expenditures for unrelated party outsourcing to the acquisition cost of the patent. Let us assume that the acquisition cost of patents is €1 million for a given company and that the rate of return is 10%. Prior to the nexus rule, €100 000 could benefit from favourable tax treatment of royalties under a patent box regime, even if the patent were only registered by the company, with the underlying R&D activity having been conducted elsewhere. With the nexus rule, no exemption will be granted if the underlying R&D expenditures have been incurred by another affiliate of the MNE group, but the royalties will still qualify for such treatment if R&D has been conducted by the taxpayer itself or outsourced to an unrelated party. The nexus rules allow favourable tax treatment only where there is ‘substance’, and they close down the profit-shifting route. Patent boxes may still increase the rate of return of R&D activity, but they may not be used for profit shifting.

## Tax rulings

Tax rulings also contribute to harmful tax competition. They are the strategy of choice for MNEs wishing to reduce their tax rate in a specific, non-transparent way. There is much anecdotal evidence about tax rulings, as a result of the ‘Lux leaks’, for example. Tax rulings refer to a variety of cases with the common feature that MNE affiliates negotiate their tax treatment with the tax administration. The ‘excess profit ruling’ granted by Belgium to selected MNE affiliates is an interesting example. Those companies were allowed to deduct from their tax base a fictitious remuneration for know-how and other advantages – let us say a kind of ‘informal capital’ – of being part of an MNE group. That ‘informal capital’ is, of course, not part of the balance sheet. The deduction reduced taxation in Belgium. No information was provided to the country of the parent company, so the corresponding taxation did not take place, and the ruling reduced the overall CIT liability of the MNE group. Egger *et al.* (2018) provide a very interesting piece of research on the effect of tax rulings. Using microdata on French enterprises, they disentangle the effect of ‘bargaining-related tax advantages’ of MNEs from the effect of usual profit shifting and from the sheer ‘size’ effect. Their estimate is a reduction of 3.6 percentage points in the effective tax rate.

Rulings are part of the policy that some countries have been following in order to compete. Their consequences go beyond tax competition: they distort competition as such in a single market. It is not by chance that they have been disputed by the European Commission Directorate-General for Competition (DG Competition). There were no other provisions in the EU Treaty to counter such practices. The policy response has been on the tax side: the BEPS agreement and a parallel EU initiative have enforced the automatic exchange of rulings. It is not difficult to understand that, with exchange of information on rulings, practices like the Belgian excess profit rulings and others lose most of their advantages: the country of the parent company will be informed and will have the opportunity to dispute the transfer pricing issue.

## Why tax competition is harmful

Some arguments have been put forward in support of tax competition. The one most cited by those who advocate tax competition is that it prevents excessive spending by governments. Another argument arises from the Ramsey rule, whereby taxes are less distortionary when they rely on an inelastic tax base<sup>11</sup>. Conversely, there is a case for lowering tax on an ‘elastic tax base’, that is to say a tax base that is highly sensitive to the tax rate. According to that view, as globalisation and profit shifting make the CIT base more sensitive to rates, tax competition should make CIT less distortionary.

These arguments are far from being convincing. It is not up to the market, but to voters, to decide on the level of government spending. Moreover, EU fiscal rules already place a cap on government spending: the growth rate of expenditure may not exceed the potential growth rate of the economy. And we do not need a second cap determined by the market.

Tax competition may also result in a misallocation of resources. Let us take two investment projects, A and B (in two different jurisdictions, A and B, respectively), with A being more profitable before tax. From an economic point of view, A should be preferred to B. But let us now assume that the tax rates in jurisdictions A and B are such that, after tax, B is more profitable than A. The firm will choose B, while A should be preferred from an economic point of view. The example indicates that differences in tax rates may distort the allocation of resources, but may also distort competition. Jurisdictions A and B are not competing on an equal footing.

Competition by means of niche regimes has been recognised as harmful: this was the policy rationale of the EU and OECD initiatives in the 1990s. More recently, the empirical evidence on patent boxes points in many cases to a ‘lose-lose’ situation: no economic benefit and a loss of tax revenue (Alstadsaeter *et al.* 2015).

There are a number of cases in which DG Competition has stated that differences in effective tax rates distort competition. Those cases refer only to rulings and preferential tax regimes, because the EU Treaty states that the general provisions of a tax regime may not be deemed to be state aids. But, from an economic point of view, what matters is the result – the difference in effective tax rates – whatever the instrument that creates the outcome. It is clearly not the job of DG Competition to dispute the effect of competition on rates, but symmetry of effects should result in a consistent policy approach, irrespective of the instrument used to distort competition in the internal market.

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11. The rule was formulated by Ramsey early in the 20th century.

## The CCTB proposal

### The content of the proposal

As indicated above, the EU Commission proposed a first version of the Directive in 2011 (European Commission 2011), but no agreement was reached at that time. The 2011 proposal came as an outcome of a mandate issued by the European Council ‘to investigate the impact of tax provisions that constitute obstacles to cross-border economic activities in the internal market and remedies thereto’. The explanatory memorandum indicates that ‘the CCTB aims to tackle some major fiscal impediments to growth (...). In the absence of common (...) rules, the interaction of national tax systems often leads to over-taxation’ (European Commission 2011: 4). There was no mention of double non-taxation, nothing about profit shifting, nothing about fair taxation. In a very strange way, a ‘set of common rules’ was translated into an optional CCCTB. At best, it should have been translated into a ‘harmonised tax base’, but the Commission’s proposal added a set of rules, for which the (at that time) 24 existing tax systems could opt.

The single market argument is still part of the policy rationale and the rationale for the current proposal, but, seven years later, times have changed. The BEPS agenda has brought to the fore the low effective tax rates paid by MNEs, and there is a clear linkage between the BEPS agenda and the CCCTB proposal:

- The relaunch of the CCCTB was part of the Communication from the Commission on an action plan for a fair and efficient corporate tax system (European Commission 2015), and the words ‘fair’ and ‘fairness’ have now found a place in the explanatory memorandum (European Commission 2016a).
- The point is clearly made that the current environment makes it easy to shift profits: the economic environment is increasingly globalised, but tax rules are set at national level, without considering the cross-border consequences.
- What is also new compared to the 2011 proposal is that the risks of double taxation and non-taxation are mentioned on equal footing. The memorandum makes the point: ‘Member States find it increasingly difficult to fight effectively, through unilateral action, against aggressive tax planning practices in order to protect their national tax bases from (...) profit shifting.’

Briefly, since 2011, the Commission has been moving from a tax policy agenda that was only ‘pro-market’ and ‘pro-business’ to a broader tax policy agenda that includes fairness and combating profit shifting and tax avoidance.

The CCTB is mandatory for companies belonging to a multinational group of which the consolidated revenue exceeds €750 million. The rules are to apply to companies and permanent establishments, with a post-BEPS definition of permanent establishment. The tax base is designed broadly, with all revenues being taxable unless expressly exempted. There is also a limited definition of business expenses. The Directive also includes a general anti-abuse rule.

## **The proposal is a two-step approach**

Stage 1 sets out a common corporate tax base (CCTB). As indicated in the introduction, it is not our intention to enter into a technical discussion, article by article, but simply to list the basic principles and to discuss the main tax policy issues.

The proposed CCTB leaves no room for tax incentives, apart from two novelties that will be discussed below. This means that there is, for example, no longer any place for patent boxes, tax shelter for specific industries, or investment allowances. Rules on depreciation are set out in the Directive and are to be part of the common tax base. The CCTB includes ‘participation exemption regimes’: this means that dividends and capital gains accruing from qualifying shareholdings are tax exempt in the hands of the parent company, if the corresponding profits have been taxed in the hands of the subsidiary. The CCTB includes and reinforces the limitation on interest deduction as a percentage of the EBITDA that is part of the ATAD 1 Directive.

Transfer pricing rules will still be used to price transactions between affiliates of an MNE group. The tax base thus determined will be subject to the CIT rate of the country where each affiliate of the MNE group is resident.

There is no consolidation in stage 1. However, the CCTB proposal includes a cross-border loss offset provision: losses incurred by a subsidiary in a given Member State are deductible from the profit of the parent company, if it is located in the EU. Today, such a possibility exists only for a branch, not for a subsidiary. Allowing cross-border loss offsetting was the topic of a draft directive that was tabled back in the 1990s but never adopted. It is now linked to a common set of rules, which changes the nature of the scheme. Without a common set of rules, losses may result in favourable rules for the tax base, and a cross-border loss offset provision was perceived as an asymmetric way (in favour of MNEs only) to harmonise the tax base. With a common set of rules, losses will, in many cases, reflect ‘true losses’.

The proposal of the European Commission postpones consolidation and formula apportionment to stage 2. Consolidation will take place at EU level. The consolidated tax base will be split among affiliates – and countries – according

to sales (1/3), tangible assets (1/3), payroll (1/6) and the number of full-time equivalent employees (1/6) of each of the affiliates. Formula apportionment is the best way of ensuring that taxes are paid where the economic activity takes place. The formula seems robust, as it relies on assets, payroll and sales. The more elements are included, the more difficult it is to manipulate the formula. Consolidation is also essential to put an end to profit shifting through transfer pricing.

In addition to the above, the proposed directive includes two novelties in stage 1: the Allowance for Growth and Investment (AGI) and a Super-Deduction for R&D.

The AGI is to grant a deduction based on the increase in equity on the balance sheet, valued at the long-term interest rate plus two percentage points. Returns on equity are to be incorporated in the tax base in a symmetric way. The AGI replicates the allowance for corporate equity (ACE) that was proposed a long time ago in the Meade report (Devereux and Freeman 1991).

There are at least two aspects to the policy rationale of the AGI (and of the ACE). The basic policy rationale is that, to ensure neutrality, a tax system should not discriminate between debt and equity, which is precisely what it does when it offers full deductions in respect of interest paid, while taxing dividends on the basis of CIT and at shareholder level. This discrimination has paved the way for profit shifting and for the use of hybrid products that create mismatches. The goal of the Allowance for Growth and Investment is twofold: to make CIT more neutral and to act against the debt shifting and double non-taxation that occurs through the use of hybrids.

The Super-Deduction for R&D is to grant the deduction of an extra 50% of qualified R&D expenditures, amounting to a 150% deduction<sup>12</sup>. The motivation is the benefit, for the EU as a whole, of raising the level of R&D expenditures to increase the potential growth rate of the EU and to catch up with more advanced economies, mainly the US. The Lisbon strategy included a target of 3% of GDP that has not yet been achieved due to the low level of private R&D. The point is made that unilateral actions by Member States might result in uncoordinated tax incentives, competing rather than mutually reinforcing each other, which should boost R&D spending to the desired level.

## Intended economic effects

The impact assessment relies on the CORTAX model to investigate the intended economic effects. The CORTAX is a computable general equilibrium model. This means that the assessed impact is the difference between two steady state situations: before and after the introduction of the CCTB. The

<sup>12</sup>. The rate is reduced to 25% for R&D expenditures above €20 million and increased to 100% for small unquoted corporations.

effect is a ‘long-term’ one, which, from an economic point of view, means when markets have reached a new equilibrium after CCCTB, but with all other things being equal. It should not be interpreted as a short- or medium-term effect. A detailed description of the model and of the results of the assessment of the CCTB may be found in Álvarez-Martinez *et al.* (2016).

At EU level, the net effect is the narrowing of the tax base. The model assumes that countries adjust their CIT rate to maintain the corresponding tax revenue constant prior to any behavioural change. Under that assumption, the cost of capital falls across the EU, boosting investment and GDP. This result indicates that there is room for improvement in the current system, even if CIT revenue remains constant. In other words, the current system appears to be sub-optimal.

## Discussion

As indicated above, the **policy rationale** of the new proposal is quite different from that of the 2011 proposal. Seven years ago, it was merely a question of removing tax obstacles and double taxation. Fairness was not part of the policy rationale. It was simply pro-market and pro-business. Being optional, it increased complexity: there was no simplification in creating an EU-wide tax system alongside 24 (at that time) national tax systems. There was no progress on fairness, since MNEs were to use the CCTB only to reduce their CIT liability. In addition, it would have opened new avenues for tax planning, rather than fighting against it. There was no clear justification for the optional character of the CCCTB, apart from making it decidedly pro-business

The CCTB is now part of the fair taxation agenda and the fight against profit shifting. The concern is also about double non-taxation, and the CCTB is mandatory for large firms. These are clearly positive points.

The case for the **two-step approach** is not clear-cut. As indicated above, the move to stage 2 is essential for ensuring that corporate income tax is paid where the economic activity takes place and to close the ‘transfer pricing route’ (inside the EU), which is one of the main avenues of profit shifting. Considering these two elements, there is a strong case for proceeding directly to the CCCTB. In addition, stage 1 is asymmetric on the consolidation issue: the Commission wants to include a cross-border loss offset provision, which will make consolidation effective for losses, but not for profits.

So why is a two-step approach being suggested? The main argument put forward by the Commission is political: it seems easier to reach an agreement in a two-step approach. However, Member States will discuss stage 1, having stage 2 in mind. Why should a Member State that loses from the CCCTB in stage 2 agree on stage 1, if stage 1 implies stage 2? Having two stages will not, in our view, result in fully separate political discussion. The negotiation process in stage 1 will therefore incorporate the views of Member States about stage 2, without including the benefits of stage 2.

The **broadness of the tax base** should be welcomed. The closure of patent boxes and of other tax incentives will create a level playing field and close avenues for profit shifting.

The **Allowance for Growth and Investment** may raise concerns. As indicated above, it builds on the Allowance for Corporate Equity that was put forward a long time ago in the Meade report. There is a case, from an efficiency point of view, for removing discrimination between debt and equity. The first argument is that symmetric treatment of debt and equity makes CIT more neutral. There is no longer any bias favouring debt. The second argument is that, by allowing deduction for the normal rate of return on equity, CIT should be levied only on economic rents (profits above the normal rate of return), and the distortionary effect of CIT on investment would be removed<sup>13</sup>. However, if this is the rationale, it should be applied in a symmetric way to debt and equity. In the proposed directive, interest deduction is not capped at the normal rate of return on capital, but subject to an interest limitation rule based on the EBITDA. Allowing a deduction for the return on equity reduces the cost of capital and thus could increase investment: this makes the case for an allowance for *new* corporate equity. However, applying it to the stock of existing equity merely increases the rate of return for shareholders holding the existing capital stock: from an economic point of view, it is simply a windfall gain and it will not increase investment. It is only a transfer from the budget to the shareholders. So the CCTB is right when it comes to restricting the application of the AGI to new equity.

The discussion may also benefit from the experience of countries that have implemented an Allowance for Corporate Equity (ACE). Croatia did this in 1994<sup>14</sup>. Belgium introduced its ‘notional interest deduction’ (NID) in 2005<sup>15</sup> and Italy an allowance for corporate equity at the end of 2011.

The Belgian NID was granted on the stock of equity. Its introduction resulted in a large windfall gain, as described above. Valenduc (2009) explains that the Belgian ACE was not designed according the principles of the ACE in economic literature, but to find a substitute for the coordination centre regime that had to be dismantled under the Code of Conduct agreement. The ‘coordination centres’ were acting as intragroup banks, funded by equity and providing debt to affiliates with no taxation of the intermediation margin. They were consequently overcapitalised. Giving them an allowance on the return on equity was a substitute for the coordination centre regime. That being the policy rationale, there was, of course, no anti-abuse rule to prevent schemes that resulted in double non-taxation. Evidence confirms that this approach was widely used by MNEs to reduce their consolidated tax bill, by locating financial companies in Belgium and organising financial flows to create double non-taxation<sup>16</sup>.

13. See OECD (2007: 125-135), for a discussion of the Allowance for Corporate Equity.

14. See Keen and King (2002).

15. See Valenduc (2009).

16. See Valenduc (2009) and Conseil supérieur des Finances (2014: 162-172).

The Italian Allowance for Corporate Equity applied only to new equity. The policy rationale was to support investment and growth through a lower cost of capital, and to remove the debt-equity bias. Anti-abuse rules were introduced to prevent double deduction and other tax planning strategies.

Zangari (2014) provides an interesting appraisal of the Belgian and Italian experiences and concludes that the Italian scheme is more efficient from an economic point of view and markedly less susceptible to tax avoidance.

The provision included in the draft directive is clearly close to the Italian version. The allowance is only for new equity, with symmetric correction for withdrawals. The draft proposal appears to aim to include anti-abuse rules that are close to those included in the Italian ACE<sup>17</sup>.

The draft directive also includes a **Super-Deduction for R&D**, to allow companies to deduct 150% of eligible R&D expenditures. The positive externalities arising from R&D<sup>18</sup> provide a justification for subsidising it. As regards the modalities, D'Andria *et al.* (2017) provide an explanation. Using a consensus estimate of the elasticity of R&D expenditures to the cost of capital, they derive the tax incentive that should allow the EU to reach the Lisbon target of 3% of GDP.

What is not clear-cut is the policy rationale for harmonisation limited to tax incentives on R&D. The Explanatory Memorandum points out that leaving countries to compete with each other to attract R&D is not the best way to reach the 3% target. The R&D Super-Deduction excludes competition only on provisions relating to the tax base, and Member States are to remain free to compete using direct subsidies and even tax credits, within the framework of the state aid rules doctrine. Harmonising the tax side only will not solve the issue of competition on R&D support and related displacement effects. Another, more comprehensive option should be control, under the state aid rules provisions, over the entire volume of R&D support.

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17. The anti-abuse rules are not included in the draft directive, which simply delegates the issue to the European Commission, which is empowered to issue regulations. The accompanying documents make reference to a list of possible anti-abuse rules similar to those in force in the Italian version of the ACE.

18. The social rate of return is higher than the private one, which justifies tax incentives or direct subsidies that increase the private rate of return, bringing it close to the social rate of return.

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## Is it the right way to go? And is it sufficient to put an end to tax competition?

A common tax base for corporate income is certainly a step forward that should be welcomed. The way the European Commission has included fairness and combating base erosion and profit shifting in its memorandum is a step in the right direction, compared to the 2011 proposal, which was purely pro-market and pro-business. Consolidation and formula apportionment will further close down BEPS routes inside the EU.

But is it enough? Countries may circumvent the common tax base by changing tax incentives from allowances to tax credits. Even if this runs counter to the spirit of the Directive, to date there is no provision in the Directive that would prevent it.

We could make a comparison with the adoption of the Code of Conduct. When it was being discussed, the EU Commission issued a communication mentioning that the state aid rules would focus more on tax incentives<sup>19</sup>. The previous doctrine, which had permitted the Irish preferential tax regimes, the Belgian coordination centres and other preferential tax regimes, was clearly revisited, and, during the negotiations on implementation of the Code of Conduct, the new doctrine was clearly the ‘stick’ for countries that were reluctant to enter into a political agreement under the Code of Conduct. There is nothing of this kind today. As the door of tax credits remains open, additional rules are clearly needed. It may be tax rules or strengthened state aid rules, or similar, but we need something to prevent countries wanting to compete using niche regimes from using the windows after the door is closed.

Another concern is that Member States are not constrained on tax rates. Countries may still compete using CIT rates to attract economic activity and taxable profits. It is time to recall what happened with CIT rates when the Code of Conduct was adopted: we observed a race to the bottom, mainly in countries of Central and Eastern Europe. It may be objected that, at that time, countries that used rates most actively to compete enjoyed an expanding tax base due to the fact that they were ‘in transition’ and attracting a lot of foreign direct investment for non-tax reasons. Those circumstances significantly reduced the fiscal cost of tax competition. Today’s situation is different, but CIT cuts adopted or announced in many countries indicate a revival of competition on rates.

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<sup>19</sup>. The communication was issued on 18 November 1997 and the political agreement setting out the Code of Conduct is dated 1 December 1997.

Under the CCTB, the transfer pricing route is still open, subject to the stricter rules agreed under the BEPS package at OECD Inclusive Framework level. As differences in rates will remain, and maybe increase, MNEs could still exploit these differences to reduce their consolidated tax bill.

Under the CCCTB, there is no possibility of attracting taxable profits as such. A country's tax base will not be profits registered in the country, but part of the consolidated tax base that will be determined according to sales, fixed assets, payroll and the size of the staff. Competition on the location of real economic activity will remain, but competition to attract 'paper profits' will no longer be possible. Engaging in tax planning would mean manipulating the factors of the formula, which is clearly more difficult.

As tax competition will remain, and considering that tax competition is harmful, the requirement arises, alongside a common, consolidated tax base, for a floor or 'corridor' for nominal tax rates.

The final concern is that the 'one-stop-shop' rule could create new forms of 'incentives' to attract the ultimate owner companies. The location of the ultimate parent will determine the tax treaty provisions that will be applied to flows into or out of the consolidated tax base. This holds for withholding taxes on dividends, interest and royalties flowing out of EU territory. This also holds for transfer pricing rules. Nobody could have imagined a customs union without a common external tariff. But that is what we have, and what will remain under the CCCTB.

Combating tax competition requires more than a common tax base. We need something more comprehensive on tax incentives, a threshold for rates, something along the lines of a common external tariff for flows going out of EU territory and enforced administrative cooperation to ensure audits in the context of consolidation.

But when the glass is half full, don't waste it. Just fill it.

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## List of abbreviations

<b>ACE</b>	Allowance for Corporate Equity
<b>AGI</b>	Allowance for Growth and Investment
<b>ATAD</b>	Anti-Tax Avoidance Directive
<b>BEPS</b>	Base Erosion and Profit Shifting
<b>CCCTB</b>	Common Consolidated Corporate Tax Base
<b>CCTB</b>	Common Corporate Tax Base
<b>CIT</b>	Corporate Income Tax
<b>CORTAX</b>	CORporate TAXation
<b>EBITDA</b>	Earnings before Interest, Tax, Depreciation and Amortisation
<b>ETR</b>	Effective Tax Rate
<b>EU</b>	European Union
<b>G20</b>	Group of Twenty
<b>GDP</b>	Gross Domestic Product
<b>METR</b>	Marginal Effective Tax Rate
<b>MNE</b>	Multinational Enterprise
<b>NID</b>	Notional Interest Deduction
<b>NMS</b>	New Member States
<b>OECD</b>	Organization for Economic Cooperation and Development
<b>R&amp;D</b>	Research and Development
<b>UN</b>	United Nations

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