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TAX

Far-reaching EU tax reform plans announced: what they could mean for corporate taxpayers

On 18 May 2021, the European Commission issued a communication on "Business Taxation for the 21st Century". The announcements made therein are expected to translate into actual legislative proposals in the next three years.

If implemented, they would represent a systemic change to corporate taxation in the EU. Several short-term proposals would build upon the existing trends of increased transparency and substance requirements, and international negotiations on Pillar One and Pillar Two. The longer-term ambition is adopting a common set of rules to determine an EU consolidate corporate tax base to be shared between member states according to a formulary apportionment (tax rates would still be determined nationally). Finally, the communication also includes measures to support taxpayers. These plans show where the EU might be heading to.

Below we classified the contemplated measures in five categories. Absent actual proposals yet, we outline for each of them the European Commission's idea and an initial high-level impact assessment.

Increasing transparency

Annual publication of the effective tax rate

The European Commission will propose, by 2022, legislation to require the annual publication of the effective tax rate (**ETR**) of certain large multinational enterprises (**MNEs**) operating in the EU. The ETR would be determined in line with Pillar Two (please find here our tax flash on the Pillar Two blueprint of October 2020).

Subject to an implementation of Pillar Two, this measure should not trigger material additional compliance costs, but it would expose large MNEs' tax affairs to additional public scrutiny, requiring greater coordination with the MNE's Environmental, Social and Corporate Governance ambitions. This measure will also have to be considered together with the current public consultation opened on the future country-by-country (**CBC**) directive (please find here our tax flash on the CBC concerns).

Additional reporting on substance and economic activity

The European Commission will also issue by year-end 2021 a proposal to fight the abusive use of "shell companies", which are companies with no or very limited substantial presence and economic activity. MNEs would have to provide additional proof of the substance and real economic activities of such companies. This would allow jurisdictions to improve exchange of information and act against the (ab)use of these types of entities, for instance by denying tax benefits (measures yet to be specified).

This proposal, if adopted, would increase the pressure on the use of intermediary holding and financing entities – especially in low- or no-tax jurisdictions where the substance is very often very limited. MNEs would likely have to restructure and focus on one or two jurisdictions to establish such entities and conduct these activities.

Increasing corporate taxation

Implementing Pillar One and Pillar Two and related measures

A first measure would be the implementation of the OECD's Pillar One and Pillar Two outcome through directives (to be proposed swiftly after reaching agreement at global level) to ensure a harmonised implementation within the EU. Building on this, the European Commission further contemplates additional steps to prevent non-taxation of outbound royalties and interests in absence of taxation at recipient level (the measure is not specified, but its need remains to be confirmed if Pillar Two includes the Subject-to-Tax Rule). The European Commission also hopes that the Council will adopt the pending recast of the Interest & Royalties Directive (making benefit conditional on taxation at recipient level – possibly even at a minimum level of tax), which was proposed years ago.

The impact of the implementation of Pillar One and Pillar Two will largely depend on the outcome of the ongoing negotiations at OECD/G20 level. In any case, large taxpayers (with a turnover of at least EUR 750 million) should expect increased taxation and tax compliance complexity due to, amongst others, a partial departure from the arm's length principle, the need to compute effective tax rates in a number of jurisdictions, adjustments to tax incentive regimes, and potential increases in nominal corporate tax rates.

The interaction and compliance with EU law – notably the fundamental economic freedoms laid down in the EU treaties – will be a key attention point as regards the application of Pillar One and Pillar Two in an intra-EU context. In relation with non-EU group entities, EU law is unlikely to offer any protection, as the freedom of establishment cannot be invoked by non-EU persons.

An EU digital levy

In addition, the European Commission also wishes to introduce a digital levy – the measure is for now on the agenda of its meeting of 14 July 2021. This digital levy would apply independently from Pillar One measures and would constitute another EU own resource.

Large MNEs with significant cross-border activities largely conducted relying on an online infrastructure will face an additional tax burden. Depending on the design (tax on gross revenue versus profits), certain activities or business models could even become financially unprofitable.

Financial transactions tax and additional contribution of the corporate sector

By the end of its mandate in 2024, the European Commission also wants to relaunch the Financial Transactions Tax (**FTT**) and propose an additional contribution by the corporate sector (to be levied based on the BEFIT tax base). Both of these measures would constitute additional own resources of the EU.

Increasing the importance of environmental taxes

Several measures, to be proposed in the coming weeks, seek to increase “green taxation” – reforming the EU Energy Taxation directive, introducing a carbon border adjustment mechanism (**CBAM**) (to prevent dumping from businesses established in countries with laxer rules against pollution) and revising the EU emission trading system (**EU ETS**) to increase the price of carbon emission rights and further incentivise businesses to upgrade their production processes in a more environment-friendly manner. The latter two measures, CBAM and EU ETS, would raise own resources for the EU.

Increasing EU tax harmonisation

The BEFIT proposal

The European Commission’s Business in Europe: Framework for Income Taxation (**BEFIT**) proposal would replace the former CCCTB proposal. If the BEFIT proposal is adopted, the profits of the EU constituent entities of MNE groups would be consolidated in a single tax base determined according to a single corporate tax rulebook. Such tax base would be allocated to Member States using a formulary apportionment. Member States would retain the prerogative of setting the tax rates. Possibly the group could file a single EU corporate tax return. The BEFIT proposal is expected in 2023.

The BEFIT proposal would further depart from the arm’s length principle (in an EU context) and would significantly reduce the possibility for smaller open economies within the EU to increase their competitiveness through tax incentive measures. At first sight, this type of measures is likely to favour larger member states. As for the CCCTB, one of the main hurdles for the BEFIT proposal will be the need for unanimity of member states (unless the European Commission seeks to rely on article 116 TFEU to pass the proposal with a majority vote only).

Pillar Two and the EU blacklist

The European Commission suggests considering the implementation of Pillar Two as additional criterion to determine whether a foreign jurisdiction should be included in the EU’s blacklist of non-cooperative jurisdictions.

If such idea is implemented, the number of jurisdictions on the EU blacklist could significantly increase (at least initially, given the EU’s ambitious timeline to implement Pillar Two). This in turn could trigger countermeasures (such as additional withholding taxation or non-deductibility of payments to group entities in blacklisted jurisdictions) that would further increase taxation of EU group entities, and additional reporting obligations (notably under DAC 6).

Supporting taxpayers through tax measures

A loss carry-back mechanism

The European Commission recommends introducing a loss carry-back mechanism in the context of the Covid-19 pandemic allowing taxpayers to carry back losses for up to 3 years and up to EUR 3 million.

This is a non-binding recommendation which could help taxpayers in jurisdictions that do not have, or have a more restrictive, loss carry-back mechanism at present.

Reducing the bias in favour of debt funding

The European Commission will propose by early 2022 a Debt Equity Bias Reduction Allowance (**DEBRA**), which should work like a notional interest deduction allowing to take a deduction for a certain (deemed) remuneration on equity.
The purpose is to reduce the tax benefits of resorting to debt financing, and thereby mitigate the risks of instability in case of economic downturn.

This is a positive step, albeit the tax bias in favour of debt financing go beyond the sole deductibility of interest. Withholding taxation can be different, and some countries also have net wealth tax for corporate taxpayers.

Next steps

The Commission will continue its work on the proposals in the next three years according to the respective timelines mentioned above, as part of its ambition to reform taxation in the EU to make it fairer, greener and better adapted to the modern economy. If and once global consensus is reached on Pillar One and Pillar Two, the Commission has indicated it will move swiftly to propose measures for its implementation in the EU.

We will keep you informed of further developments. In the meantime, should you have any query, please reach out to our digital economy taxation team, our EU tax team or your trusted Loyens & Loeff contact.