The **BEPS** Monitoring Group

COMMENTS ON
THE EUROPEAN COMMISSION'S PROPOSAL
BUSINESS IN EUROPE: FRAMEWORK FOR INCOME TAXATION (BEFIT)

These comments by the BEPS Monitoring Group (BMG) respond to the Call for Evidence issued by the European Commission in relation to an impact assessment of its proposals for a new EU framework for income taxation for businesses. The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, and Oxfam. This report has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. It has been drafted by Sol Picciotto, with contributions from Christiana Hzi-Panayi, Jeffery Kadet, Séverine Picard and Jim Stewart.

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Summary

We strongly support the Commission's longstanding view that the fairest and most efficient approach to taxation of business profits within the EU's single market is by adopting a common corporate tax base together with formulary apportionment. Indeed, in our view this approach should be adopted worldwide, as the only effective way to reform international tax rules to ensure that multinational enterprises (MNEs) can be taxed 'where economic activities occur and value is created', as mandated by the G20 for the project on base erosion and profit shifting (BEPS) initiated by the OECD. Detailed rules have been formulated for implementation of both Pillars, and the Commission's proposed Directive based on the rules for Pillar Two has now been agreed by the Council of the EU.

These developments have completely changed the context for action by the EU on business taxation. This should indeed provide a 'source for inspiration' for the BEFIT, as the consultation document states. Indeed, we would go further and suggest that the Commission should in principle base its detailed proposals on the rules developed for Pillars 1 and 2, e.g. on consolidated accounts, and the definitions of assets, employees and sales by destination. This would ensure that this EU initiative is firmly in line with the global consensus.

In particular:

(i) the tax base should be global consolidated accounts, adjusted for tax purposes as agreed for Pillar 1, excluding all state aids or tax expenditures such as non-refundable tax credits; non-EU-based MNEs should also submit global consolidated accounts, as well as a consolidation at the EU level;

(ii) the assets factor should not include intangibles;

(iii) a simplified method should be developed to identify risks of profit-shifting outside the EU, but it should use a formulaic method, to complement the BEFIT applied within the EU;

(iv) administration should be through a 'one-stop shop' in a 'college' system involving representatives of all affected member states.

The Commission should be congratulated on its far-sightedness in identifying this objective, and should take heart from the progress now achieved. The time is now ripe to take a further decisive step forward, and for the EU to provide the leadership needed to complete the long-overdue reform of international corporate tax rules, both within the EU and more widely.

I. General Comments

We strongly support the Commission's longstanding view that the fairest and most efficient approach to taxation of business profits within the EU's single market is by adopting a common corporate tax base together with formulary apportionment. Indeed, in our view this approach should be adopted worldwide, as the only effective way to reform international tax rules to ensure that multinational enterprises (MNEs) can be taxed 'where economic activities occur and value is created', as mandated by the G20 for the project on base erosion and profit shifting (BEPS) initiated by the OECD. The BEPS project now involves 141 jurisdictions through the Inclusive Framework on BEPS, which in 2021 reached agreement on a Two Pillar solution. Detailed rules have been formulated for implementation of both Pillars, and the Commission's proposed Directive based on the rules for Pillar Two, which has now been agreed by the Council of the EU.

These developments have completely changed the context for action by the EU on business taxation. The two pillars now directly address the issue of allocation of MNEs' global profits, and include all the elements needed for formulary apportionment. Pillar One defines a methodology to determine MNEs' global consolidated profits, by making specified adjustments to the financial accounts for tax purposes. This differs from, and in our view supersedes, the EU's previous approach, which was to specify common rules for the corporate tax base to be applied at national level, and aggregated at EU level. Pillar One also provides for an allocation of a share of those profits among countries in proportion to sales, based on detailed rules to define sales by destination, dealing also with the difficult issues of digitalised services and the valuation of user contributions. Furthermore, Pillar Two identifies the other two factors that should be used in the formula for allocating profits to reflect real activities - physical assets, and employees - and also includes detailed rules to define and quantify these.

This should indeed provide a 'source for inspiration' for the BEFIT, as the consultation document states. Indeed, we would go further and suggest that the Commission should in principle base its detailed proposals on these rules. This would ensure that this EU initiative is firmly in line with the global consensus that has resulted from the painstaking work of the BEPS project, as well as providing a further spur for a shift towards worldwide adoption of formulary apportionment.

The Commission's low-key approach to the BEFIT proposal is understandable in view of the difficulties experienced over the lengthy period since it set out its long-term objective of adoption of a common consolidated corporate tax base in 2001.[1] In our view, the Commission

[1] Communication: Towards an Internal Market without tax obstacles A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities, COM(2001) 582, 23.10.2001.

should be congratulated on its far-sightedness in identifying this objective, and should take heart from the progress now achieved.

The time is now ripe to take a further decisive step forward, and for the EU to provide the leadership needed to complete the long-overdue reform of international corporate tax rules, both within the EU and more widely. The obstacles are now essentially political. Many national governments still need to be convinced that such a coordinated approach is essential to restoring their true tax sovereignty. However, the adoption of a global minimum corporate tax under Pillar Two should succeed in finally placing a floor on the competition to reduce effective corporate rates. The design of the minimum tax refocuses attention on ensuring that profits are aligned with real activities (physical assets and employees). These factors , together with sales, are those which are essential for the creation and realisation of profits. Allocating rights to tax on the basis of these factors would be a major step towards both integration of the single market and to ensuring its competitiveness, by encouraging states to provide the best environment to attract the key drivers of profit: investment in physical assets, jobs, and sales to consumers.

II SPECIFIC COMMENTS

A. Scope

In our view, adoption of the BEFIT would place competition within the single market on a much better basis, benefiting all businesses in the long run. Hence, we support a wide scope to include SMEs that operate across national borders or could appropriately do so. We suggest that the threshold should be based on the EU annual accounts Directive, which sets annual reporting requirements for MNE groups, and defines medium sized companies as those with an annual turnover of €40 million and 250 employees.[2]

We agree that the definition of "a group of companies" that would be in scope should be aligned with the definition in article 3(3) of the Directive on Ensuring a Minimum Level of Tax for Multinational Groups within the European Union (COM(2021) 823 final). However, it should also take into account, perhaps in explanatory material, the definition of a 'group' now provided in the draft rules for Amount A in Pillar One. This makes clear that the definition applies regardless of whether consolidated accounts are actually prepared by a group, provided that the entities would be treated as consolidated under the relevant acceptable accounting framework.

However, this must not be optional if there is to be a real level playing field. Allowing each business the option to make its own decision would encourage tax arbitrage, and be antithetical to the proposal's aim of enhancing the single market.

We also agree that a wide scope should mean no sectoral carveouts. Adjustments of the allocation factors and/or formula could be appropriate where a good case can be made, perhaps for financial services for example. However, this should be given very careful consideration, particularly in view of the economic importance of the financial sector, and its generally high profitability. According to a recent study, profit shifting by the top European banks is estimated to be around 5% of the total profits booked abroad.[3]The ease with which profits from financial services can be attributed to locations out of line with economic substance means that a formulary method is particularly important for this sector. Hence, any

[2] Art 3, Directive 2013/34 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings

[3] M. Barake (December 2022), Tax Planning by European Banks, EU Tax Observatory Working Paper n°9

special treatment should be limited to ensuring that the formula factors are appropriate and effective.

B. Tax Base Calculation

In our view, the approach of Pillar One has much to commend it, and the rules agreed by the Inclusive Framework should be adopted for the BEFIT as far as possible, unless a good case can be made for variation. The Pillar One approach that starts from financial accounts may not be as theoretically refined as rules formulated purely for tax purposes as suggested in Option 2, but this is outweighed by its greater simplicity. Further, it has proved easier for a large number of states to agree rules based on this approach compared to the lengthy negotiations over the CCTB.

However, it is important to specify adjustments to the financial accounts, so that the rules do not allow state aids or tax expenditures, for example through non-refundable tax credits or other notional allowances. To ensure fairness, transparency and good governance, government support for business should not be done through tweaks to the tax base.

In principle, this should mean starting from the consolidated financial accounts of each MNE corporate group. Many businesses, especially SMEs, operate only within the EU single market, so this would be appropriate and convenient for them. A difficulty arises for the larger MNE groups that have entities outside the EU, because the BEFIT is proposed to apply only within the EU. However, in our view it is better to start from group accounts that have been consolidated according to financial accounting rules, rather than the approach adopted previously in the CCCTB, of starting from national-level accounts and simply aggregating them. This would mean that MNE corporate groups with entities outside the EU should be required to prepare consolidated accounts at the EU level. Although this would entail some compliance costs for the affected businesses, once appropriate accounting systems have been designed these should be minimal.

Restricting the BEFIT to apply only within the EU leaves significant scope for the shifting of profits to havens outside the EU. We address this issue in section D below.

C. Formula for allocating taxable profits

We strongly oppose including intangible assets in the allocation formula. This would be completely antithetical to the basic principle of allocation of profits in relation to the real factors that generate profits. It should be borne in mind that the aim is to allocate the income actually earned, and not possible future earnings that most commonly provide the basis for valuing intangibles for accounting purposes. The accumulated know-how of a business is very important to its success, but much of this is tacit or personal, due to the knowledge and skills of the workforce, and generated by the practical experience in the activities of the enterprise. Goodwill is also sometimes considered an intangible asset, but like general know-how, its location or value is very hard to determine, and it cannot be protected as an alienable asset.

Alienable intangible assets are intellectual property rights. By definition they are non-material, their very existence depends on legal concepts and provisions. This has two key consequences. First, the valuation of intangibles is highly imprecise, even notional, since it depends on legal as well as scientific or technological uncertainties. Secondly, intangibles have no physical location. Exploitation of these fictions has been central to strategies of international tax avoidance, because their ownership can easily be attributed to any entity. It is for this reason that they have been disregarded in the rules of the two Pillars, such as the substance-based carve-out in Pillar Two. Like the two Pillars, the aim of the BEFIT is to ensure that the allocation of profits is in line with the real activities of a business. The inclusion of intangible assets in the formula would defeat the central aim of the BEFIT, which should be to allocate rights to tax actual income, in relation to the physical location of real activities.

The value of intangibles results from numerous sources, in particular (i) research and development, which essentially means people and physical infrastructure such as laboratories, as well as (ii) marketing and sales, including promotion, advertising, cultivating relationships with clients, and collecting data about customers. Hence, the three key factors used for formulary apportionment (physical assets, employees and sales) are also a very good surrogate for allocating the income resulting from both production and marketing intangibles. Under an apportionment approach, the aim is not to attribute profits to specific assets or activities, but to allocate the total profits resulting from the synergy of the combined activities of a corporate group or business, among the countries where those activities physically take place.[4] This should also include the location of sales, which are essential to the realisation of profits. This has become increasingly important in the light of the digitalisation of the economy, which has greatly facilitated cross-border sales particularly of services. Detailed sourcing rules for the attribution of sales based primarily on the location of the customer have now been developed under Pillar One.

D. The Allocation of profit to related entities outside the group.

The incentive for MNEs to shift taxable profits out of the EU will be diminished once the Directive on a Minimum Level of Tax for Multinational Groups comes into effect. However, the minimum effective tax rate has been set at 15%, with carve out and sectoral exclusions, while the average statutory corporate tax rate in Europe, weighted by GDP, is 24%. This still leaves scope for continued profit-shifting out of the EU. The introduction of the BEFIT for intra EU transactions only is likely to significantly increase incentives for non-EU tax planning, undermining the useful effect of the BEFIT, and continuing the pressure to reduce the rate, so that the minimum could become a maximum.

It is therefore important to ensure a fair allocation of profit of MNE groups that operate both within the EU single market and outside.

Option 1 suggests that a methodology could be developed that would not replace existing rules, but would “provide guidance on tax authorities’ risk approach to businesses’ transactions with related entities outside the corporate group”. We agree that a simplified method should be formulated to identify risks where there has been an inappropriate allocation of profit as between the EU consolidated group and the other parts of the MNE group. This should complement the adoption of formulary apportionment by the BEFIT, by also applying a formulaic method. A formulary approach is the only way to truly simplify the allocation of MNE income for tax purposes, and increase tax certainty for business.

The formulation of such an explicit methodology to identify risks could do much to deter profit-shifting behaviour. In cases where profit has been shifted to entities that are not covered by existing tax treaties, the formulaic method could be directly applied. However, where this is considered to be precluded by an applicable tax treaty, the tax authority concerned should ensure close scrutiny of the structures that have resulted in a significant

[4] When especially physical assets and payroll are used as surrogates for intangibles that have lasting value, such lasting value may be reflected by including some number of historical years’ numbers in each current year’s computation. For example, maybe the includible R&D expenses for the prior three years are included in the relevant physical asset and payroll for the current year’s computation.

deviation between the income allocations indicated by the formulaic method and these declared by the MNE.

Adoption of a formulaic approach has been considered, notably by India, in a public consultation in 2019. This was to multiply the revenues from sales in India by the global operational profit margin of the MNE, and then attribute the taxable profits using an apportionment methodology.[5] The adoption of the BEFIT by the EU would be a further significant step towards a more general shift to formulary apportionment.

Option 1 seems to suggest something very different, to use benchmarking to simplify existing "one-sided" transfer pricing methods, which focus on specific members of a corporate group. In our view, simplification is incompatible with the requirement in the OECD Transfer Pricing Guidelines for an individual analysis of the facts and circumstances of each entity within an MNE group to determine its functions, assets and risks, and a search for comparables. This makes simplification impossible in practice, as can be seen from the discussion of Safe Harbours in chapter IV of the Guidelines. This points out that safe harbours "primarily benefit taxpayers",[6] although there may be some benefit for tax administrations in helping them to use better their scarce resources, by focusing on more high-risk situations. The difficulties have also been evident in the lengthy and continuing efforts to try to agree a simplified method for distribution and marketing in Amount B under Pillar One.

As a final comment on this issue, the application of traditional benchmarking means that under almost all situations the level of profit benchmarked for EU group members will not reflect any of the profits from group synergies and group intangibles that benefit all group members. An approach based on formulary apportionment that includes all worldwide group members importantly avoids this result that artificially lowers the profits recognized by EU group members. Such a worldwide approach may be used conveniently to determine transfer pricing risk even if it is not directly used to determine actual taxable income in each member country. Even where existing transfer pricing rules continue to be applicable, it is important that they should ensure an allocation of profits in line with real activities, and a formulary apportionment should now be recognised as the appropriate benchmark for this.

E. Administration

The BEFIT is much less complex than existing methodologies based on the separate entity principle. Hence, its introduction should greatly reduce the compliance costs for both business and tax administrations, once the system becomes established and teething problems are resolved. Particularly in this early phase, however, it is clearly important to ensure good coordination among the relevant tax authorities, to minimise conflicts and prevent any need for resort to tribunals. This should be ensured by providing for a one-stop-shop, in a 'college' system involving the tax authorities of all affected member states. This could follow the proposals for the CCCTB and for Pillar 1, with primary responsibility for a designated principal tax authority, or perhaps through a centrally administered Clearing House.

[5] India, Ministry of Finance, Central Board of Direct Taxes, "Public consultation on the proposal for amendment of the rules for profit attribution to a permanent establishment", 18 April 2019, available at https://www.incometaxindia.gov.in/news/public_consultation_notice_18_4_19.pdf. The new article 12B in the UN Model Convention includes a similar method: it provides an option, at the choice of the taxpayer, for taxing the net income from automated digital services derived by applying the MNE's global profit rate (for the relevant type of business if segmented accounts are available) to the local revenues, 30% of which is attributed to the source.

[6] OECD Transfer Pricing Guidelines 2022, para. 499, p. 204.