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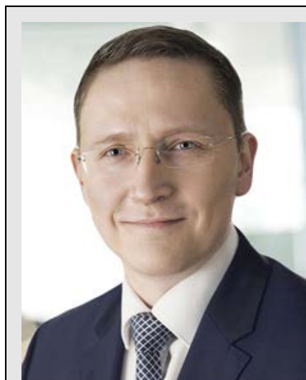
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In this article, Hoor examines the structure of the Business in Europe: Framework for Income Taxation proposal and questions whether it is the best path for the European Commission to follow.

Introduction

On September 12 the European Commission adopted the directive proposal Business in Europe: Framework for Income Taxation (BEFIT).[1] BEFIT aims to "introduce a common set of rules for EU companies to calculate their taxable base while ensuring a more effective allocation of profits between EU countries, based on a formula."

The directive proposal on BEFIT replaces — and thus repeals — the commission's proposal for a common corporate tax base and the proposal for a common consolidated corporate tax base that have never reached consensus. However, BEFIT strongly resembles the previous CCCTB proposal.

The BEFIT proposal establishes a common set of rules to determine the tax base of companies subject to corporate income tax in an EU member state as part of a group that prepares consolidated financial statements. Moreover, BEFIT would require the aggregated tax base of the members of the BEFIT group members to be allocated based on formulary apportionment. If adopted by the EU Council, the BEFIT proposal would enter into force on July 1, 2028.

The BEFIT System

Scope of a BEFIT Group

The BEFIT rules would be mandatory for companies belonging to a domestic group or to a multinational enterprise group resident for tax purposes in a member state (including permanent establishments in other member states) and for PEs located in member states of entities resident for tax purposes in a third country (third-country entities) if they:

- prepare consolidated financial statements; and
- had annual combined revenues of €750 million or more in at least two of the last four fiscal years.

The ultimate parent entity (UPE) of the group must also hold at least 75 percent of the ownership rights or have 75 percent profit entitlement for an entity to be part of the BEFIT group.

While BEFIT's mandatory scope is similar to that of pillar 2 (groups with annual combined revenues of at least €750 million), it would be limited to the EU subset group of entities that meets the 75 percent ownership threshold, assessed on a yearly basis (BEFIT group members).

The directive proposal would not apply to companies or PEs with a UPE outside the EU if the combined revenue of the group inside the EU either does not exceed 5 percent of total group

[1] European Commission, Proposal for a Council Directive on Business in Europe: Framework for Income Taxation (BEFIT), COM(2023) 532 final (Sept. 12, 2023).

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revenue based on its consolidated financial statements or €50 million in at least two of the last four fiscal years. Thus, non-EU MNE groups with a limited presence in the EU would be out of scope.

MNE groups that would not fall within the mandatory scope of the BEFIT rules may choose to opt in as long as consolidated financial statements are prepared. The directive proposal scope does not contain sector-specific exclusions.

Computation of the Tax Base

Under the directive proposal, BEFIT group members would need to calculate their tax base in accordance with a common set of rules. Like in pillar 2, the starting point will be the accounting result from the financial accounts, which must be determined under one single accounting standard for the BEFIT group. To this aim, the financial accounts of each BEFIT group member will have to be reconciled, in principle, with the accounting standard of the UPE.

For simplification purposes, adjustments under BEFIT would be kept to a minimum, rather than putting together a detailed corporate tax framework. If not already in the financial accounting statements, BEFIT would require the following items to be added back:

- financial assets held for trading;
- borrowing costs that are paid to parties outside the BEFIT group in excess of the interest limitation rule of the anti-tax-avoidance directive (ATAD);
- fair value adjustments and capital gains received by life insurance undertakings in the context of unit-linked and index-linked contracts;
- fines, penalties and illegal payments such as bribes; and
- corporate taxes that were already paid or top-up taxes in application of pillar 2.

At the same time, the following elements would be subtracted from the financial net income or loss if they are in the financial accounts:

- dividends and capital gains or losses on shares or ownership interests of significant ownership (at least 10 percent of the profits, capital, reserves or voting rights and held for more than one year) unless they are held for trading or by a life insurance undertaking;
- the profit or losses from PEs;
- shipping income subject to a national tonnage tax regime;
- rollover relief for gains on assets that are replaced;
- acquisition, construction and improvement costs of depreciable assets because these costs will already be part of the depreciation base and subsidies directly linked to this because subsidies should neither be in the depreciation nor tax base;
- unrealized gains or losses from currency exchange fluctuations on fixed assets; and
- any amount relating to the post-allocation adjustments listed in article 48 of the directive proposal.

Hence, BEFIT would require fewer and different tax adjustments (like dividends and capital gains exclusion) than pillar 2 which has a different purpose, namely to calculate the appropriate qualifying income when determining the minimum level of tax due. The scope of the exclusion for dividends and capital gains under BEFIT is also different to the Luxembourg participation exemption.

The directive proposal provides for BEFIT tax depreciation rules for fixed assets and so-called timing and quantification rules to avoid perceived abuse. For example, provisions are excluded if they are not legally required or cannot be reliably estimated; bad debts can only be deducted under certain conditions and never if the debtor is an associated enterprise; the treatment of hedging instruments must follow the tax treatment of the hedged item.

The directive proposal further includes rules for entities entering or leaving the BEFIT group and business reorganizations to clarify; for example, that the merger directive takes precedence.

Finally, the directive proposal includes an antiabuse rule that would require capital gains on assets to be included in the preliminary tax result when the assets are moved within the group, without tax implications, to a group member and is then sold out of the group. This would normally benefit from a tax exemption for share disposals

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but would not be allowed under BEFIT, unless it can be justified from a commercial perspective.

Aggregation of the BEFIT Group's Tax Base

The preliminary tax results of all BEFIT group members would need to be aggregated into a single pool at the EU group level. This will be the BEFIT tax base. If it is positive in a given year, the profit would be allocated to the BEFIT group members according to formulary apportionment.

If the BEFIT tax base were negative, the loss would be carried forward and may offset against the next positive BEFIT tax base at the EU group level.

Aggregating the preliminary tax results of all BEFIT group members to obtain the BEFIT tax base would result in:

- cross-border loss relief allowing the BEFIT groups to set off losses across borders;
- no withholding taxes on transactions such as interest and royalty payments within the BEFIT group, as long as the beneficial owner of the payment is a BEFIT group member; and
- facilitation of transfer pricing compliance: The arm's-length principle would be replaced by formulary apportionment (even though transactions would still need to adhere to the arm's-length standard) and would remain strictly applicable for transactions with non-EU members of the group.

The directive proposal would lead to a drastic change in the corporate tax system, which would obviously raise concerns about public finances because it seems impossible to predict the exact effect on the public finances of the EU member states. Most likely, corporate tax revenues would change significantly, either up or down.

Formulary Apportionment

Once the BEFIT tax base is determined, the (positive) aggregated tax base would be allocated to each member of the BEFIT group based on a transition allocation rule. Each member of the BEFIT group would have a percentage of the aggregated tax base calculated on the basis of the average of the taxable results in the previous three fiscal years.

For each fiscal year between July 1, 2028, and June 30, 2035 (at the latest — the transition period), the BEFIT tax base would be allocated to the BEFIT group members in accordance with the following baseline allocation percentage:

$$\text{Baseline allocation} = \frac{\textit{Taxable result of a BEFIT group member}}{\textit{Total taxable result of the BEFIT group}} * 100$$

According to the commission, the transitional allocation rule should:

> pave the way for a permanent allocation method that can be based on a formulary apportionment. In designing a permanent allocation method, the transitional solution would make it possible to take into account more recent county-by-country reporting data and information gathered from the first years of the application of BEFIT. It would also allow for a more thorough assessment of the effect that the implementation of the OECD/G-20 inclusive framework two pillar approach is expected to have on national and BEFIT tax bases.

In addition, the commission announced that, if appropriate, it may propose a directive in which the aggregated tax base will be allocated based on a factor-based formula.

Upon allocation, each BEFIT group member would have a part of the BEFIT group's profit. On this part, the group member will have to apply additional adjustments in its tax assessment. These would mostly include technical corrections that are necessary for the coherence of the system (for example, the deduction of pre-BEFIT losses).

Finally, to ensure member states' competence in tax rate policies, the directive proposal would allow them to introduce further deductions, tax incentives, or base increases, to the extent that these comply with the EU directive on minimum tax and pillar 2.

A Critical Review of the BEFIT Initiative

This section addresses several concerns raised by the BEFIT initiative.

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National Sovereignty of EU Member States

The corporate tax laws of EU member states vary from state to state reflecting the respective economies. Notably, EU member states have the freedom to make tax policy choices in line with the desired incentives for their economies. EU member states' national sovereignty over tax matters is a fundamental EU principle, and unanimity is required for policy changes.

The commission has made several attempts to move to a qualified majority voting (in which measures can be approved by a minimum number of EU countries, representing a minimum share of the EU population), but to date these attempts have failed.

In my view, moving to qualified majority voting in taxation will undermine the competitiveness of the EU because it would diminish the pressure on national authorities to pursue efficient and competitive tax policies, resulting in higher taxation across the EU.

The BEFIT initiative would undermine national sovereignty over tax matters through the backdoor because it would largely replace domestic tax laws with an EU corporate tax system over which individual member states would have only limited control.

Absence of a Need for BEFIT

Since the time of the CCCTB proposal, the European and international tax landscape has undergone a dramatic transformation. Following the OECD base erosion and profit-shifting project, the commission adopted several directives that aimed to tackle perceived tax evasion and tax avoidance.

The two anti-tax-avoidance directives (ATAD (2016/1164) and ATAD 2 (2017/952/EU)) provide a number of strict antiabuse provisions that had to be transposed into the domestic tax laws of EU member states. Tax transparency has been elevated to a new level through the various amendments of the Directive on Administrative Cooperation (DAC1 through DAC8). The commission also released a draft directive on the misuse of EU shell entities[2] (ATAD 3, also referred to as the "Unshell Directive" (COM(2021) 565 final)).

Other important changes to the international tax landscape have been advanced by the OECD. The multilateral instrument resulted in the implementation of antiabuse provisions such as the principal purposes test in covered bilateral tax treaties. In 2017 and 2020, the OECD revised its transfer pricing guidelines in accordance with the guidance developed as part of the OECD's follow-up work on BEPS actions 8-10 and 13. More recently, a directive on ensuring a global minimum level of taxation for multinational groups in the Union has been passed.

Hence, the corporate tax laws of EU member states have already been significantly amended, and tax authorities have a comprehensive arsenal of antiabuse rules that allows them to tackle any kind of abusive situation (as well as reporting requirements that should allow them to be aware of any residual abuse).

Absence of a Legal Basis for BEFIT

The purported legal basis of the BEFIT initiative is article 115 of the Treaty on the Functioning of the European Union, which stipulates that legal measures are vested in the legal form of a directive. However, the EU's competences are governed and limited by the principles of subsidiarity and proportionality if the directive is imperative for the functioning of the internal market.

The Principle of Subsidiarity

The general aim of the principle of subsidiarity is to guarantee a degree of independence for a lower authority in relation to a higher body or for a local authority in relation to central government. It therefore involves the sharing of powers between several levels of authority. It is a principle that forms the institutional basis for federal states.

When applied in an EU context, the principle of subsidiarity serves to regulate the exercise of the Union's nonexclusive powers. It rules out EU intervention when an issue can be dealt with effectively at the member states' central, regional, or local level. The EU is justified in exercising its powers only when member states are unable to achieve the objectives of a proposed action

[2] Shell entities are entities lacking a minimum level of substance for tax purposes.

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satisfactorily and the EU can provide added value.

On page five of the explanatory memorandum of the directive proposal, the commission claims that:

> Businesses in the Union increasingly operate across borders in the internal market, but the current tax framework in the Union consists of 27 different corporate tax systems. This multiplicity of rules results in fragmentation and presents a serious impediment to business activity in the internal market. Indeed, cross-border businesses face high tax compliance costs in the internal market, as they must comply with various legal frameworks. . . . These problems are common to all Member States and cannot be effectively addressed by national actions. As they are the result of having different tax systems in the first place, national uncoordinated action would produce insufficient effects. . . . In this context, only a Union-wide initiative providing for a common set of rules can be effective.

The Principle of Proportionality

The envisaged measure must also comply with the principle of proportionality. Accordingly, a measure must not go beyond what is required to ensure the minimum necessary level of protection for the internal market.

Assessment

The commission's legal basis is in article 115 of the TFEU to the extent the directive proposal:

- is imperative for the functioning of the internal market; and
- adheres to the principles of subsidiarity and proportionality.

The commission claims that the need for BEFIT for the functioning of the internal market lies in the fact that the complexity of 27 tax systems creates an impediment to businesses and undermines the competitiveness of the internal market. This can only be tackled by laying down legislation at the EU level.

However, it is questionable that this initiative, which would result in extreme complexity and legal uncertainty for years to come, is required for the functioning of the internal market because the tax laws of EU member states have already been significantly amended over the last decades. Further, differences in tax systems are consistent with the member state sovereignty in tax matters which cannot be undermined by invoking article 115 of the TFEU.

Even if it could be established that some tax law changes would be imperative for the functioning of the internal market, the BEFIT initiative's aim to implement a European corporate tax system must be inconsistent with the principles of subsidiarity and proportionality. In my view, the commission should have no authority to intervene.

However, it comes as no surprise that the explanatory memorandum of the directive proposal reaches the conclusion that BEFIT is in line with both the principles of subsidiarity and proportionality.

Tax Treaty Override

Bilateral tax treaties concluded between EU member states allocate an unlimited primary taxing right of business profits to a company's residence state. Other EU member states may only tax part of the business profits of the company to the extent it has a PE in their territory and business profits are attributable to it.

Transfer prices charged for the transfer of goods and services between associated enterprises must comply with the arm's-length principle. Otherwise, tax authorities of the contracting states may perform tax adjustments with a view to restate arm's-length conditions.

Formulary apportionment as proposed under BEFIT would be inconsistent with the tax treaty obligations of EU member states, undermine the arm's-length principle, and represent tax treaty override.

While legitimate EU law prevails over domestic tax laws and tax treaties in the EU context, one should keep in mind that the tax treaties concluded by EU member states are generally based on the OECD model. The concepts and principles included in the OECD model have been developed over time and agreed

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upon at the global level by OECD countries (all EU member states belong to the OECD).

BEFIT's overwriting of these fundamental tax principles on transactions between EU companies would eliminate the great accomplishments of bilateral tax treaties and not be an improvement as suggested by the commission.

Continued Chronic Legal Uncertainty

The implementation of BEFIT has the potential to result in years (and likely more than a decade) of chronic legal uncertainty. While numerous tax law changes over the last few years have already resulted in significant legal uncertainty, a large part of existing domestic tax laws have a long history, including extensive guidance and established case law.

Replacing these domestic tax systems with a new set of rules that might be interpreted differently in different EU member states would be an adventure for taxpayers and EU member states alike. Considering that it may take up to 10 years until the Court of Justice of the European Union takes up a case (cases must go through the courts of the member state before it can be referred to the CJEU), it would take a long time before the new rules would be settled.

This would mean that taxpayers and tax authorities would need to dedicate more resources to ensuring compliance and settling the disputes resulting from the legal uncertainty.

Complexity and Costs

While the European Commission claims that the objective of BEFIT is to decrease complexity, compliance costs and legal uncertainty, the opposite seems to be the case. Introducing a new corporate tax system that would operate in parallel to the existing 27 corporate tax systems would be a significant burden on taxpayers and tax administrations.

The interaction of BEFIT and the minimum tax rules of pillar 2 would increase complexity to an unprecedented level, the results of which cannot be reliably anticipated. This would result in significant compliance costs and make the EU a less attractive place to do business.

According to the explanatory memorandum of the proposal directive:

> the costs of the proposal cannot be determined with any precision because the BEFIT proposal does not have a precedent and there is no dedicated data that can be used reliably for concrete estimates.
>
> However, BEFIT would entail:
> - ongoing operational costs;
> - short-term (one-off) adjustment costs related to updating IT systems; and
> - the training of staff and tax administrations to adjust to the new system.

Unpredictable Impact on Public Finances

BEFIT would require:

- the determination of the tax base according to a new set of rules;
- the aggregation of the tax bases of the members of the BEFIT group; and
- the allocation of part of the aggregate tax base to individual members based on formulary apportionment.

During a transition period, the allocation would be based on the average of the taxable results of the previous three fiscal years. Thereafter, a new allocation key would be developed for formulary apportionment.

Hence, the arm's-length principle would be replaced by formulary apportionment (although transactions would still need to adhere to the arm's-length standard). However, for transactions with non-EU members of the group, the arm's-length principle would need to be strictly applied.

This drastic change of the corporate tax system would raise concerns about public finances because it is difficult to predict the exact effect on the budgets of EU member states. Most likely, corporate tax revenues would change significantly, one way or the other.

In addition, it should not be forgotten that such a fundamental change of the corporate tax system may create unintended incentives for multinational groups to reduce their economic activity in a member state or the EU altogether. For example, multinational groups might consider shifting shared service centers and production to jurisdictions with low salary costs.

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Conclusion and Outlook

The goal of the BEFIT initiative is the adoption of a common set of rules for EU companies to calculate their corporate tax base and the allocation of profits between EU member states based on formulary apportionment.

According to the explanatory memorandum, "the idea to develop a common corporate tax framework in support of the internal market has always been part of the Union's history and first appeared in policy documents of the European Economic Community as early as the 1960s." Hence, it can be assumed that it was always part of a (hidden) agenda to move toward a European corporate tax system.

While the explanatory memorandum complains that "businesses have to comply with (up to) 27 different national tax systems, making it difficult and costly for companies to do business across the Union," complexity and compliance costs did not seem to be a major concern for the commission when adopting countless tax initiatives over the last decade.

More truth about the real motive for the BEFIT initiative might be found in the statement that "in 2020, the Council, Parliament and the Commission agreed that a common corporate tax base could be the basis for a new own resource that the Commission will propose." Could it be that the real intention is to create a new source of own-tax revenue for the EU in addition to contributions by EU member states?

Ultimately, it remains to be seen whether the member state governments will unanimously give up their sovereignty in tax matters or if BEFIT will share the fate of the previous CCTB and CCCTB initiatives. ■

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