

The Common Consolidated Corporate Tax Base and the UK Tax System

Dr Christiana HJI Panayi

***Copyeditor:* Carol Franklin**

November 2011

THE INSTITUTE FOR FISCAL STUDIES

TLRC Discussion Paper No. 9

Published by

The Tax Law Review Committee

The Institute for Fiscal Studies

7 Ridgmount Street

London

WC1E 7AE

(Tel: +44 (0)20 7291 4800)

(Fax: +44 (0)20 7323 4780)

(email: mailbox@ifs.org.uk)

(website: www.ifs.org.uk)

© Institute for Fiscal Studies, November 2011

ISBN 978-1-903274-57-6

This discussion paper was written for the Tax Law Review Committee by Christiana HJI Panayi. The views expressed do not necessarily represent the views of the Committee. The Committee has authorised its publication to promote debate on European Commission's proposal for a Common Consolidated Corporate Tax Base, whether this proposal should be adopted in the UK and to elicit comments for its ongoing work in this area. Comments should be sent to the Research Director, Malcolm Gammie, at the Institute for Fiscal Studies or mgammie@oeclaw.co.uk.

The Tax Law Review Committee

President Rt Hon. The Lord Howe of Aberavon CH QC
Chairman Sir Alan Budd

Members

Dr John Avery Jones CBE	<i>formerly</i> Judge of the First-tier and Upper Tax Tribunals
Mamie Boland	<i>formerly</i> Assistant Solicitor, HMRC
Tracey Bowler	Solicitor's Office
Sir Geoffrey Bowman KCB QC	TLRC Researcher
Anneli Collins	First Parliamentary Counsel
Bill Dodwell	2002–06
Professor Judith Freedman	Tax Partner, KPMG
Malcolm Gammie CBE QC	Tax Director, Tax Policy Group, Deloitte & Touche LLP
Paul Johnson	Professor of Tax Law, University of Oxford
Graeme Macdonald	One Essex Court
Brian Mace	TLRC Research Director
David Martin	Director, IFS
Ian Menzies-Conacher	University of Kent
Jane Moore	Policy Director, Inland Revenue, 1990–2004
Paul Morton	<i>formerly</i> Senior Tax Partner, Herbert Smith
His Honour Sir Stephen Oliver KCB, QC	<i>formerly</i> Group Taxation Director, Barclays PLC
Dr Christiana HJI Panayi	Low Incomes Tax Reform Group
Christopher Sanger	<i>formerly</i> Technical Director of TaxAid
Gordon Slater	Tax Director, Reed Elsevier
Simon Sweetman	<i>formerly</i> President, First-tier Tax Tribunal
Chris Tailby CBE	TLRC Researcher
Professor John Tiley CBE QC	Ernst & Young LLP
John Whiting OBE	<i>formerly</i> Director of Taxation, Cadbury Schweppes plc
	Chairman, Tax and Financial Affairs Committee, Federation of Small Businesses
	Director of Tax Practice, Customs & Excise, 2002–10
	Professor of Law, Queens' College, University of Cambridge
	Tax Policy Director, The Chartered Institute of Taxation

Corporate sponsors

The Association of Tax Technicians

Barclays PLC

The Chartered Institute of Taxation

Citigroup Global Markets Limited

Ernst & Young LLP

GlaxoSmithKline PLC

ICAEW Faculty of Taxation

Imperial Tobacco Group PLC

KPMG LLP

PricewaterhouseCoopers LLP

Reed Elsevier Group plc

Schroder Investment Management Limited

Scottish & Newcastle plc

Travers Smith Braithwaite LLP

Executive summary

This report examines the European Commission's draft plans to introduce a Common Consolidated Corporate Tax Base (CCCTB) for EU group companies. It analyses the basic features of the draft proposal, as published in the draft CCCTB Directive of 16 March 2011 and the possible effects of these on the UK tax system. The report focuses on areas such as formulary apportionment, loss relief, intra-group transfers, reorganisations, the administration of the new system, taxation of inbound and outbound investment, and anti-abuse rules. Throughout this report, there is a comparison of the proposed rules with the UK provisions.

Even though the Commission does not, for political reasons, acknowledge the possibility of Member States abstaining from the CCCTB, it is very likely that unanimity will not be reached in Council and any proposal will have to proceed via enhanced co-operation. The report examines the application of enhanced co-operation in this context and considers how the rules of the CCCTB will be modified vis-à-vis non-CCCTB Member States. The report also considers how non-CCCTB Member States (taking the UK as an example) will be affected, especially by the CCCTB anti-abuse provisions and the rules on the taxation of inbound and outbound investment (as drafted and as potentially modified).

The report concludes by questioning whether it would be desirable for the UK to adopt the CCCTB or whether it should opt out. The repercussions of each course of action are summarised.

Table of contents

- The Common Consolidated Corporate Tax Base and the UK Tax Systemi
- Executive summary v
- Table of contents..... vi
- 1. Introduction.....1
- 2. The CCCTB proposal5
 - 2.1 Key features.....5
 - 2.2. Optionality: co-existence of domestic regimes and the CCCTB10
 - 2.3 Tax base harmonisation12
 - 2.4 Consolidation and cross-border loss relief.....17
 - 2.5 Consolidation and other benefits.....22
 - 2.6 Formulary apportionment.....25
- 3. The UK tax system and the CCCTB31
 - 3.1 The UK tax base31
 - 3.2 Cross-border relief for losses32
 - 3.2.1 Group relief rules.....32
 - 3.2.2 Group relief for overseas permanent establishment losses37
 - 3.2.3 ‘Group relief’ within the CCCTB.....38
 - 3.2.4 Group relief versus consolidation40
 - 3.3 Intra-group transfer of assets.....43
 - 3.3.1 UK rules43
 - 3.4 Participation exemption47
 - 3.5 Administration.....48
 - 3.5.1 UK rules48
 - 3.5.2 Administration under the CCCTB49
 - 3.6 Conclusions.....55
- 4. Adoption of the CCCTB in the UK57
- 5. Inbound and outbound investment60
 - 5.1 General60
 - 5.2 Outbound investment – inbound payments60
 - 5.3 Inbound investment – outbound payments65
- 6. Anti-abuse rules.....71
 - 6.1 Generally71
 - 6.2 Controlled foreign companies73
 - 6.3 Thin capitalisation81
- 7. Conclusions.....91

1. Introduction

1.1. The Commission has recognised that taxation and customs policies have a significant role to play for the EU to become the most competitive economy in the world.¹ Double taxation, high compliance and tax-related restructuring costs resulting from the co-existence of 27 different corporate tax systems raise obstacles to cross-border activity. The removal of these obstacles would improve market access, increase competition, and spur investment and innovation, enhancing the competitiveness of the EU productive sector.

1.2. As a means to this end, the Commission has been focusing its attention on a very ambitious project: the Common Consolidated Corporate Tax Base (CCCTB). The CCCTB is a proposal to provide companies with establishments in at least two Member States with the opportunity to compute their group taxable income according to one set of rules, those of the new consolidated tax base, rather than according to the national tax bases of each Member State. The overall aim of the CCCTB is to reduce the costs of complying with 27 tax regimes, to minimise tax arbitrage and to simplify restructurings. It is also aimed at providing comprehensive consolidation of profits and losses on an EU basis. In other words, the CCCTB is essentially a 28th system.

1.3. The Commission has expressed the belief that companies would only be able to take full advantage of the Internal Market if they have the possibility to use a common consolidated corporate tax base for their economic activities in the EU.² 'Without such a tax base their rivals from the USA and also Japan will retain a distinct competitive advantage.'³

1.4. Despite initial scepticism by many that the working group would reach any conclusion, the preliminary work of various sub-groups established to consider different aspects of the CCCTB was to an extent completed by 2008. In September 2007 the Commission published a technical outline of a possible proposal for a CCCTB, which was subsequently annotated. Since then, the Commission has been working on the basis of that proposal, accepting comments and representations from a number of bodies and Member States.⁴

1.5. The Commission was initially expected to make a legislative proposal on the CCCTB by the end of 2008. However, at the annual International Fiscal Association (IFA) general meeting in Brussels, Commissioner László Kovács hinted that the planned introduction of the CCCTB would be delayed. In his keynote speech at the Congress of IFA, Mr Kovács said that the Commission was in the process of preparing a detailed impact assessment and a comprehensive legislative proposal, without specifying the deadline for these.⁵ Even though he

¹ Commission, *The Contribution of Taxation and Customs Policies to the Lisbon Strategy*, COM(2005) 532.

² Commission Non-Paper to informal Ecofin Council, 10 and 11 September 2004, *A Common Consolidated EU Corporate Tax Base*, 7 July 2004, page 2. Also see Rolf Diemer & Thomas Neale, 'The European Union's Longer-Term Plans for Introducing a Common Consolidated Tax Base for the EU-wide Activities of Companies', 89A (2004) *Cahiers de Droit Fiscal International* 69, 73.

³ *Ibid.*

⁴ See, for example, the last version of the main technical discussion document released after the 12th meeting of the CCCTB Working Group, in December 2008: CCCTB/WP057annotated\doc\en: 'CCCTB: Possible Elements of a Technical Outline – Annotated' (henceforth, CCCTB/WP057annotated). This document had incorporated representations made, *inter alia*, by the European Business Initiative on Taxation (EBIT), Business Europe CCCTB Task Force, the Association of Foreign Banks in Germany. EUROCHAMBRES, Federation of German Industries (BDI) and Comité Européen des Assurances (CEA).

⁵ See keynote speech at the Congress of the International Fiscal Association, 31 August 2008, reported in *Tax Analysts* (2008 WTD 171-13). Also see Lee Sheppard, 'EU Tax Commissioner Puts CCCTB Proposal on Hold', reported in *Tax Analysts*, 5 September 2008 (2008 WTD 173-1).

claimed to be fully committed to the CCCTB project, there were no official developments after that speech.

1.6. There were probably a number of contributing factors to this. First, in a referendum in Ireland in June 2008, the Irish people rejected the Lisbon Treaty. Fears of tax harmonisation and further erosions to the Member States' fiscal sovereignty were some of the reasons why the Lisbon Treaty was rejected. Following this general rejection, it was, perhaps, not thought to be prudent to present such an important legislative proposal. Second, it appeared from the work-in-progress reports of the CCCTB Working Group, published on the Commission website, as well as in other public events, that the proposal had not reached the required level of maturity and comprehensiveness to be presented to Council. Third, the business lobby did not appear to be convinced or fully supportive of any proposal, though their position was reserved.

1.7. Recently, there has been renewed momentum. With the ratification of the Lisbon Treaty⁶ and the appointment of Commissioner Algirdas Šemeta, who promised, *inter alia*, to deliver a proposal on the CCCTB as soon as possible,⁷ there was optimism for further action in the near future. It was thought that the Commission would be making a proposal as early as in the first quarter of 2011.⁸ Following a workshop held in Brussels on 20 October 2010, the Commission released four papers refining the earlier proposal.⁹

1.8. On 16 March 2011, the Commission published the eagerly awaited final proposal for a Council Directive on a Common Consolidated Corporate Tax Base (henceforth, the draft CCCTB Directive)¹⁰ and a detailed impact assessment.¹¹ As the Commission stated in its press release,¹² the aim of the proposal was to reduce significantly the administrative burden, compliance costs and legal uncertainties that businesses in the EU currently face by having to comply with up to 27 different national systems for determining their taxable profits. The Commission extolled the proposal, in that it would offer companies a 'one-stop-shop' system for filing their tax returns, as well as provide for consolidation. It was estimated that on a yearly basis the CCCTB would translate into savings in

⁶ The last Member State to ratify the Lisbon Treaty on 4 November 2009 was the Czech Republic. For commentary, see Peter Cusson, 'The Lisbon Agreement' (2009) *Tax Journal*, issue 1004, 15. The Lisbon Treaty comprises the Consolidated Versions of the Treaty on European Union and the Treaty on the functioning of the European Union (OJ 2010/C 83/01). These two treaties have replaced the Treaty on the European Union and the EC Treaty.

⁷ See summary of his pre-appointment hearing at the European Parliament on 12 January 2010, reported in *Tax Analysts* (2010 WTD 9-9). Also see speech given by Commissioner Algirdas Šemeta on 1 March 2010 in the Brussels Tax Forum entitled 'Tax Policies for a Post-Crisis World'. This was reported in *Tax Analysts* on 2 March 2010 (2010 WTD 40-13). For commentary, see, *inter alia*, Charles Gnaedinger, 'New EU Tax Commissioner Might Favor Harmonized Corporate Tax Base' (2010 WTD 30-7); Patricia Lampreave Márquez, 'New EU Tax Commissioner's Policy May Spell Success', 58 *Tax Notes Int'l* 465 (10 May 2010). More recently, see speech entitled 'A Smart Tax Agenda for Europe' given by Commissioner Šemeta on 28 June 2010, at the ECOFIN meeting (SPEECH/10/347).

⁸ See Annexes to the Commission's Work Programme 2011, COM(2010) 623 final (found at http://theopemptou.com/portal/images/stories/cwp2011_annex_en-20101110175909.pdf).

⁹ See CCCTB/RD\001\doc\en: 'Eligibility Tests for Companies and Definition of a CCCTB Group' (henceforth CCCTB/RD\001); CCCTB/RD\002\doc\en: 'Business Reorganisations in the CCCTB' (henceforth CCCTB/RD\002); CCCTB/RD\003\doc\en: 'Transactions and Dealings between the Group and Entities outside the Group' (henceforth CCCTB/RD\003); CCCTB/RD\004\doc\en: 'Anti-abuse Rules in the CCCTB' (henceforth CCCTB/RD\004). Also see Commission's CCCTB roadmap:

http://ec.europa.eu/governance/impact/planned_ia/docs/2008_taxud_001_ccctb_en.pdf

¹⁰ Brussels, COM(2011) 121/4, 2011/0058 (CNS); SEC(2011) 316 final.

¹¹ Commission Staff Working Document Impact Assessment Accompanying Document to the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), Brussels, 16.3.2011, SEC(2011) 315 final. Also see Commission Staff Working Paper, Summary of the Impact Assessment – Accompanying Document to the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), SEC(2011) 316 final (henceforth, Summary Report of the Impact Assessment).

¹² IP/11/319, dated 16/03/2011.

compliance time and costs.¹³ It was also claimed that the new system would bring tangible benefits for companies wishing to expand into other Member States.¹⁴

1.9. Now that the Commission has reverted with a coherent proposal, the adoption of a Union¹⁵ legislative measure such as this Directive will require unanimity¹⁶ among Member States. This is becoming more and more unlikely.¹⁷ There had already been suggestions to allow a few Member States to adopt the CCCTB under the enhanced co-operation procedure, even before the Commission postponed its work on it.¹⁸ This procedure is explained in greater detail below.¹⁹

1.10. It should be noted, however, that in the drafting of the main technical document,²⁰ as amended by the four papers recently released,²¹ the Commission was proceeding on the assumption that *all* Member States would adopt the CCCTB. The draft CCCTB Directive follows that approach. Legally, the Commission can only propose measures for adoption by all Member States. As a corollary, in its draft plans, the Commission does not seem to be factoring in the possibility of Member State abstainers. This creates additional problems in trying to delineate the impact of the CCCTB on potential non-CCCTB Member States such as the UK.

1.11. This report focuses on the potential benefits and drawbacks of the CCCTB and the overall viability of the proposal, mainly from a *UK perspective*. The aim is to consider how the UK would be affected if it participates in the CCCTB and if it does not participate.²² In order to do so, it is essential to examine how CCCTB and non-CCCTB countries will be affected by the key features of the new regime, such as consolidation and cross-border loss relief. It is also important to consider how transfer pricing and separate accounting will be applied vis-à-vis third countries

¹³ The Commission estimated that the CCCTB would save businesses across the EU €700 million in reduced compliance costs, €1 billion in reduced costs to expand cross-border and €1.3 billion through consolidation. It was also estimated that businesses looking to expand cross-border would benefit from up to €1 billion in savings. See press release IP/11/319, dated 16/03/2011. Also see MEMO/11/171, dated 16/03/2011, p.2.

¹⁴ As the Commission noted, currently, it costs a large enterprise over €140,000 in tax-related expenditure alone to open a new subsidiary in another Member State. The CCCTB would reduce these costs by €87,000 or 62%. Medium sized enterprises stand to gain even more, with their average tax-related costs of expanding within the EU dropping from €127,000 to €42,000 (a decrease of 67%). If even just 5% of SMEs were to decide to expand on this basis, overall savings would be of the order of €1 billion. See MEMO/11/171, fn.13, p.5.

¹⁵ Following the Lisbon Treaty, the Treaty on European Union (TEU) is amended and the Treaty establishing the European Community (EC Treaty) is amended and renamed as the Treaty on the Functioning of the European Union (TFEU). Thereafter, the 'European Union' replaces and succeeds the 'European Community'.

¹⁶ Unlike indirect taxes and the explicit tax base for harmonisation found in Art 113 TFEU (ex Art 93 EC), for direct taxes there were never any express legislative bases in successive European Treaties. The general legislative bases found in Arts 115 and 352 TFEU (ex Arts 94 and 308 EC) have been used for direct tax legislation. Unanimity is required under all of these provisions. Article 116 TFEU (ex Art 96 EC), another general legislative base, only requires qualified majority voting but has never been used to enact direct tax legislation.

¹⁷ See report in *Tax Analysts* explaining the objections raised by some Member States; namely, Poland, Latvia, Slovakia, Czech Republic and Bulgaria. Most of these Member States refer to the administrative difficulties faced by the authorities and small and medium sized enterprises, the narrower tax base that would yield lower revenues, formulaic apportionment, the elective nature of the scheme and the unclear rules. Charles Gnaedinge, News Analysis: CCCTB Opponents Stake Out Different Positions, *Tax Analysts International* (21 November 2008).

¹⁸ See Luca Cerioni, 'The Possible Introduction of Common Consolidated Base Taxation via Enhanced Cooperation: Some Open Issues' [2006] 5 *European Taxation* 187. The possibility of enhanced co-operation was referred to, *inter alios*, by Philip Baker & Ioanna Mitroyanni, 'The CCCTB Rules and Tax Treaties', and Malcolm Gammie & Christiana HJ Panayi, 'Inbound Investment and Thin Capitalization', in Michael Lang, Pasquale Pistone, Josef Schuch & Claus Staringer, *Common Consolidated Corporate Tax Base* (Linde, 2008). For an economic analysis, see Leon Bettendorf, Albert van der Horst, Ruud A. de Mooij & Handrik Vrijburg, 'Corporate Tax Consolidation and Enhanced Co-operation in the European Union', (2009) Oxford University Centre for Business Taxation WP 10/01.

¹⁹ See Part 2.1.

²⁰ See CCCTB\WP\057\doc\en: 'CCCTB: Possible Elements of a Technical Outline' (Meeting to be held on Thursday 27 and Friday 28 September 2007) (henceforth CCCTB57), annotated in December 2008 in CCCTB\WP057annotated, fn.4.

²¹ See fn.9.

²² This is irrespective of any eventual decision by the UK whether or not to participate. It is most unlikely that any proposal will command sufficient support from the current UK government or, indeed, any prospective government in the near term.

or non-CCCTB countries, as well as the taxation of investment into and out of the CCCTB area.

1.12. The proposal has to confront the multiplicity of complex issues that have to be solved under domestic corporation tax systems. The development of the tax base is, obviously, a key issue. The framework for developing and amending the specific rules of the proposal as well as resolving the administrative aspects (e.g. audits, exchange of information, dispute resolution, etc.) raise just as many concerns. The drafting of appropriate anti-abuse rules to deal with issues such as CFCs, thin capitalisation etc. is also a challenge.

1.13. Furthermore, it is imperative to ensure the compatibility of the proposal with the case law of the Court of Justice, especially as it will operate between those Member States that opt into the regime and those that do not, and as between entities within the regime and those outside it. The relationship between the CCCTB and bilateral double taxation treaties within the EU, and with third countries, raises further issues that ought to be addressed, if treaty overrides are to be avoided. This is especially important given the wide range of the UK's tax treaty network. It is important to evaluate the functionality of each of these aspects of the CCCTB proposal and their impact on any decision by the UK to participate or not, so as to safeguard its interests.

2. The CCCTB proposal

2.1 Key features

2.1.1. The CCCTB is a proposal to provide companies with establishments in at least two Member States²³ with the possibility of computing their group taxable income according to one set of rules, those of the new consolidated tax base,²⁴ rather than national tax bases.

2.1.2. The first salient feature of this proposal is the common tax base. The CCCTB aspires to provide cogent rules for the calculation of the tax base of group members that elect to adopt the CCCTB – in Member States where the CCCTB is available for election, if the CCCTB proceeds with enhanced co-operation.²⁵ The second salient feature is consolidation; i.e. the automatic set-off of profits and losses and the elimination of intra-group transactions for the consolidated group members (if different from the CCCTB group members). These are considered in greater detail below.

2.1.3. The CCCTB applies to EU companies (whether or not under ultimate EU ownership).²⁶ These are the so-called eligible companies, which can opt to apply the common tax base.²⁷ An eligible company must take one of the forms listed in Annex I to the draft CCCTB Directive and must be subject to corporate taxes in a Member State as listed in Annex II or to a similar tax introduced subsequently.²⁸ A company established under the laws of a third country can also benefit from the Directive if the company has a similar form to one of the forms listed in Annex I and the company is subject to one of the corporate taxes listed in Annex II.²⁹

2.1.4. Only eligible companies that are tax resident in a Member State³⁰ and not under the terms of a tax treaty resident in a third country may opt for the system provided for in the Directive.³¹ A company resident in more than one Member State shall be considered to be resident in the Member State in which it has its place of effective management.³² If a company is not tax resident in a Member State, then it may opt for the system provided for in the draft CCCTB Directive

²³ Commission officials previously stated that the CCCTB will also be available to purely domestic groups; i.e. domestic groups will have the ability to elect to become a group for CCCTB purposes. The comments were made during the Vienna conference on the CCCTB organised by the Commission in co-operation with the Institute for Austrian and International Tax Law (21–23 February 2004). For a report of the proceedings of the conference, see Tigran Mkrtchyan, ‘Vienna Conference on “Common Consolidated Corporate Tax Base – The Possible Content of Community Law Provisions”’ [2008] 6 *European Taxation* 317. The proposal contemplates this.

²⁴ For details of the new tax base, see the draft CCCTB Directive, fn. 10, Parts 2.2–2.3, CCCTB57, fn.20, paragraphs 19–84 and CCCTB/WP057annotated, fn.4. For this and all other CCCTB documentation see http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm [Accessed 23 January 2011]. Also see Parts IV & V in Lang et al. (2008) fn.18.

²⁵ See paragraph 1.9 and below.

²⁶ See Art 2(1) of the draft CCCTB Directive. There had also been suggestions for the CCCTB to be extended to partnerships and other entities such as foundations, co-operatives, associations, etc. See, for example, Claus Staringer, ‘Requirements for Forming a Group’, Robert Danon, ‘Common Consolidated Corporate Tax Base (CCCTB) and Hybrid Entities’, in Lang et al. (2008) fn.18, p. 213. Also see comments made by Christoph Spengel at the proceedings of Seminar 1: ‘IFA/EU – consolidated tax base seminar’, at the 2008 IFA Congress in Brussels, noted in Ulli A. Konrad, ‘The Common Consolidated Corporate Tax Base in the European Union’, [2009] 5/6 *Bulletin for International Taxation*, pp.252, 254.

²⁷ See Art 2(1) and Art 6 of the draft CCCTB Directive. Also see CCCTB/RD\001, paragraph 4, fn.9.

²⁸ See Art 2(1) of the draft CCCTB Directive.

²⁹ *Ibid*, Art 2(2).

³⁰ *Ibid*, Art 6(1).

³¹ *Ibid*, Art 6(3) and (4).

³² *Ibid*, Art 6(4).

vis-à-vis a permanent establishment maintained by it in a Member State.³³ A permanent establishment is defined in Art 5 of the draft CCCTB Directive. The definition is almost identical to the definition in Art 5 of the OECD Model.³⁴

2.1.5. The draft CCCTB Directive clarifies that an EU company, which opts for the CCCTB, will be subject to corporate tax under that system on all income derived from any source, whether inside or outside its Member State of residence.³⁵ A company in a third country, which opts for the CCCTB, will be subject to corporate tax under that system on all income from an activity carried on through a permanent establishment in a Member State.³⁶ In fact, where a company qualifies and opts for the CCCTB, 'it shall cease to be subject to the national corporate tax arrangements in respect of all matters regulated by [the draft CCCTB] Directive unless otherwise stated'.³⁷

2.1.6. The new tax base will not be compulsory.³⁸ It is only when the option to apply the Directive is exercised that eligible taxpayers satisfying a single test will be subject to mandatory consolidation (the all-in, all-out principle). As widely expected following the criticism of the double threshold tests of the initial draft proposal,³⁹ there is now a single threshold test for group membership and consolidation, albeit a two-part or two-threshold test, as indicated in the preamble.⁴⁰ Therefore, all CCCTB group members are automatically consolidated. In other words, there are no longer 'CCCTB non-consolidated group members'.

2.1.7. The starting point is Art 54 of the draft CCCTB Directive, which explains who are qualifying subsidiaries. These include all immediate and lower-tier subsidiaries in which the parent company holds the following rights: a right to exercise more than 50% of the voting rights;⁴¹ an ownership right amounting to more than 75% of the company's capital or more than 75% of the rights giving entitlement to profit.⁴² Contrary to CCCTB/RD\001,⁴³ it is not immediately

³³ *Ibid*, Art 6(2).

³⁴ There are some subtle differences. For example, for the purposes of the draft CCCTB Directive, a taxpayer can only be considered to have a permanent establishment in a State other than the State in which its central management and control is located. Art 5(1). There is no such stipulation in Art 5 of the OECD Model. Also, in certain places, the draft CCCTB Directive refers to 'taxpayer' or 'another person' (see Art 5(3)(a), Art 5(3)(c), Art 5(6) by way of example), rather than enterprise.

³⁵ Art 6(6) of the draft CCCTB Directive.

³⁶ *Ibid*, Art 6(7). It is noteworthy that draft CCCTB Directive and CCCTB/RD\001 refers to permanent establishments of third country companies only, as it is not yet envisaged that there will be non-CCCTB Member States.

³⁷ Art 7.

³⁸ See Art 6 of the draft CCCTB Directive. Also see Explanatory Memorandum to the Directive, p.5, Commission Communication, *Implementing the Community Lisbon Programme: Progress to date and next steps towards a Common Consolidated Corporate Tax Base (CCCTB) of 5/4/2006*, COM(2006) 157 final, p.8. This was also reiterated by a European Commission official, Mr Tom Neale, at the IFA 2008 Congress. See Konrad, fn.26, p. 253. Also reported on Tax News Service Online, 4 September 2008. For criticism of the optionality approach, see Johanna Hey, 'CCCTB – Optionality', in Lang et al. (2008) fn.18, pp.93, 106–113; Ilan Benshalom, 'A Comprehensive Solution for a Targeted Problem: A Critique of the European Union's Home State Taxation Initiative' [2008] 12 *European Taxation*, pp.630, 636–637.

³⁹ See CCCTB/WP\057\doc\en, fn.20 and CCCTB/WP\057annotated, fn.4. The benefits and disadvantages of lower and higher thresholds were analysed in the summary record of the CCCTB Working Group's meeting held in December 2007: CCCTB/WP\64/en: 'Summary Record by the Chair of the Meeting of the Common Consolidated Corporate Tax Base Working Group' (10–11 December 2007), pp.4–6.

⁴⁰ See paragraph 16, which reads as follows: 'Eligibility for consolidation (group membership) should be determined in accordance with a two-part test based on (i) control (more than 50% of voting rights) and (ii) ownership (more than 75% of equity) or rights to profits (more than 75% of rights giving entitlement to profit).[...]'

⁴¹ Art 54(1)(a) of the draft CCCTB Directive. This is subject to the rule in Art 54(2)(a) that once the voting-right threshold is reached in respect of immediate and lower-tier subsidiaries, the parent company will be deemed to hold 100% of such rights.

⁴² Art 54(1) of the draft CCCTB Directive. This is subject to the rule in Art 54(2)(b) that entitlement to profit and ownership of capital will be calculated by multiplying the interests held in intermediate subsidiaries at each tier. Ownership rights amounting to 75% or less held directly or indirectly by the parent company, including rights in companies resident in a third country, will also be taken into account in the calculation.

⁴³ In CCCTB/RD\001, the first condition was that the level of ownership exercised over a subsidiary by a parent company was set at a threshold of >75%. There was a slight discrepancy in the text of the recent discussion

apparent from Art 54(1) whether the existence of these rights is a cumulative requirement or an alternative one. However, as mentioned immediately above, in the preamble to the draft CCCTB Directive, the Commission appears to consider the test to be a two-part one, suggesting that the existence of the rights in subparagraphs (a) and (b) of Art 54 is a cumulative requirement (with ownership and rights to profits in subparagraph (b) being alternatives).⁴⁴

2.1.8. In any case, the thresholds need to be maintained throughout the tax year.⁴⁵ A taxpayer shall become a member of a group on the date when the thresholds are reached.⁴⁶ These thresholds have to be met for nine consecutive months otherwise the taxpayer would be considered never to have been part of the group.⁴⁷

2.1.9. In CCCTB/RD\001 the Commission had set out examples of group structures eligible for consolidation.⁴⁸ The basic approach was to include into the CCCTB all operations within the CCCTB Member States, even where parts of the group were located outside of the EU. However, this would only be allowed if the third country exchanged information on request to the standard of the Mutual Assistance Directive.⁴⁹ This rule was buttressed by another specific anti-abuse rule preventing double deductions in the so-called 'sandwich cases'.⁵⁰ Broadly, where a third country company was interposed between a parent company and its lower tier subsidiary and this company was located in a jurisdiction that did not exchange information on request to the standard of the Mutual Assistance Directive, the structure would not be eligible for consolidation under the common rules.⁵¹

2.1.10. In the draft CCCTB Directive it is clarified that a resident taxpayer shall form a group with: (a) all its EU permanent establishments; (b) all permanent establishments located in a Member State of its qualifying subsidiaries resident in a third country; (c) all its qualifying subsidiaries resident in one or more Member States; (d) other resident taxpayers, which are qualifying subsidiaries of the same company, which is resident in a third country and has a similar form to those listed in Annex I.⁵² A non-resident taxpayer shall form a group in respect of all its permanent establishments located in Member States and all its qualifying subsidiaries resident in one or more Member States (and their EU permanent establishments).⁵³

2.1.11. Under CCCTB/RD\001, the existence of an intermediary non-CCCTB group company did not seem to break the group – i.e. sandwich situations could

document (CCCTB/RD\001) as it referred to the threshold of '>75%' (paragraph 9) but it was later stated that the 'level of ownership exercised over a subsidiary by a company would be set at a threshold of 75% of the capital of a company' (paragraph 11). The second condition was that the parent company must have a right to exercise >50% of the voting rights in a subsidiary. CCCTB/RD\001, fn.9, paragraphs 9 and 12. The third condition was that the parent company must be entitled to >75% of the profits available from the immediate and lower-tier subsidiaries. CCCTB/RD\001, fn.9, paragraphs 9 and 13.

⁴⁴ See paragraph 16 of the Preamble, fn.401.

⁴⁵ Art 58(1) of the draft CCCTB Directive.

⁴⁶ *Ibid*, Art 58(2).

⁴⁷ *Ibid*. The wording of the draft CCCTB Directive is slightly erroneous as it refers to the taxpayer being 'treated as if it had never having become a member of the group'. CCCTB/RD\001 did not specify if the nine months were to be consecutive (see paragraph 10) but this was mentioned in the slides on the topic, released by the Commission following a workshop on 20 October 2010. See

http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/ccctb_en.htm paragraph 10.

⁴⁸ CCCTB/RD\001, paragraphs 14–18.

⁴⁹ *Ibid*, paragraph 17.

⁵⁰ In these situations, a third country company is interposed between two CCCTB group members (i.e. EU Company 3 is the subsidiary of a third country company, Company 2, which itself is the subsidiary of another EU Company 1). See rule (v), in CCCTB/RD\004, fn.9, paragraphs 25–26. Also see analysis in Part 6 below.

⁵¹ *Ibid*, paragraph 26.

⁵² Art 55(1).

⁵³ Art 55(2).

exist. The same appears to apply in the draft CCCTB Directive, as under Art 54 lower-tier subsidiaries satisfying the test for consolidation could also be qualifying subsidiaries. However, as far as third country intermediaries were concerned, the availability of consolidation under CCCTB/RD\001 was predicated on there being effective exchange of information. By contrast, under the draft CCCTB Directive, exchange of information is not mentioned in the provisions for qualifying subsidiaries and the formation of group. Although there are separate rules on disallowance of interest deductions for interest paid to an entity resident in a third country with which there is no agreement on the exchange of information,⁵⁴ it is not entirely clear whether the absence of such a criterion in the provision for formation of a CCCTB group means that lack of exchange of information can be a vitiating factor. All the examples given by the Commission in CCCTB/RD\001 and the accompanying slides seem to suggest that the eligibility (for consolidation) of a group structure involving the subsidiaries or permanent establishments of third country qualifying subsidiaries depended on the third country being a co-operating one.

2.1.12. In any case, once the option to become a CCCTB group and, as a corollary, mandatory consolidation occur, the consolidated tax base will then be subject to apportionment according to a commonly agreed formula. The formula for apportioning the tax base comprises three equally weighted factors – labour, assets and sales.⁵⁵ If the membership/consolidation test is not satisfied, then the taxpayer may still apply the common tax base for the purpose of determining its individual tax base.⁵⁶ This will be on a voluntary basis, depending on whether the Member State adopts the CCCTB as an additional rather than as its unique tax base.

2.1.13. Contrary to misconceptions, the CCCTB will not affect tax rates. The CCCTB seeks to harmonise the tax base and *not* the tax rates. In other words, the CCCTB determines the portion of the consolidated tax base that belongs to a Member State. Member States will be entitled to tax the income apportioned to them as they wish.⁵⁷ This was reiterated by the Commission upon the release of the draft CCCTB Directive.⁵⁸ It was emphasised that Member States would maintain their full sovereign right to set their own corporate tax rate. Not only that, but in the Q&A document released by the Commission on 16 March,⁵⁹ it was in fact suggested that Member States may even choose to apply a different tax rate for the CCCTB than for their own national tax base if this was deemed to be necessary for maintaining the same effective tax rate.⁶⁰

2.1.14. The Commission's proposal was expected to take the form of a Directive under Article 115 TFEU (ex Article 94 EC), which requires unanimity in Council. The Directive, once approved, was expected to be supplemented by

⁵⁴ Art 81. Also see Part 6.3.

⁵⁵ See Art 86 of the draft CCCTB Directive, analysed in Part 2.6. Also see the precursor to the formula, set out in CCCTB/WP060\doc\en: 'CCCTB: Possible Elements of the Sharing Mechanism' (10, 11 and 12 December 2007), pages 7–15, 17. Also see Part 2.6 below. For a criticism of the proposal, see Robert Cline, Tom Neubig, Andrew Phillips, Christopher Sanger & Aidan Walsh, 'Study on the Economic and Budgetary Impact of the Introduction of a Common Consolidated Corporate Tax Base in the European Union', (Ernst & Young 2011). The study was commissioned by the Irish Department of Finance, based on the CCCTB as it stood in 2008.

⁵⁶ CCCTB/RD\001, fn.9, paragraph 2.

⁵⁷ For a view that the CCCTB should be accompanied by a compulsory minimum corporate tax rate see Christoph Spengel, 'Common Corporate Consolidated Tax Base – Don't Forget the Tax Rates', (2007) *EC Tax Review* 118–120. Also see Christoph Spengel & Carsten Wendt, 'A Common Consolidated Corporate Tax Base for Multinational Companies in the European Union: Some issues and options', Oxford University Centre for Business Taxation WP 07/17 (2007), available for download at: <http://www.sbs.ox.ac.uk/centres/tax/papers/Pages/PaperWP0717.aspx>. [Accessed 23 January 2011].

⁵⁸ Also see Commission document listing tax policy achievements during Commissioner László Kovács' five-year tenure. This document was published on 10 February 2010, in *World Tax Daily* (2010 WTD 27-9, 31).

⁵⁹ See MEMO/11/171, fn.13.

⁶⁰ *Ibid*, p.6.

implementing measures, produced under the Comitology procedure.⁶¹ As already mentioned,⁶² the likelihood of attaining unanimity in Council for the adoption of the CCCTB seemed unlikely, even before the Irish veto. Arguably, adoption via enhanced co-operation is already being (unofficially) considered, even by the Commission.

2.1.15. Pursuant to enhanced co-operation procedure,⁶³ a minimum of nine⁶⁴ Member States can adopt a measure between themselves that is not applicable vis-à-vis other non-participating Member States. Although all Member States can participate in the Council deliberations, only participating Member States can vote on it.⁶⁵ Unanimity of the participating Member States is required.⁶⁶

2.1.16. Under the EU Treaties, enhanced co-operation can only be used as a measure of last resort.⁶⁷ Acts adopted in the framework of this procedure only bind participating Member States⁶⁸ but their implementation cannot be impeded by the other Member States.⁶⁹ This means that the CCCTB will be applicable in those Member States only. Even though acts adopted within the framework of enhanced co-operation will not be part of European law and cannot affect non-participating Member States, nevertheless these Member States are under an obligation not to impede the implementation of these acts. The possible implications of this duty of non-impediment are considered throughout this report.

2.1.17. Given the current attitude of some Member States towards tax reform, it may be that enhanced co-operation will be the only means through which the CCCTB can ever come into existence. In a European Parliament resolution,⁷⁰ the Commission's efforts to establish the CCCTB were supported⁷¹ and the intention to launch it even in the framework of enhanced co-operation was welcomed.⁷² It was, however, pointed out that this was 'a second-best solution as, in the absence of a comprehensive EU-wide system, the benefits of transparency and lower administrative costs may be partly mitigated'.⁷³

2.1.18. Following the release of the draft CCCTB proposal, it is widely expected that the debate on the use of the enhanced co-operation procedure is likely to be reinforced.

⁶¹ This procedure is set out in the so-called Comitology Decision. Under this Decision, in adopting the measures required, the Commission is to be assisted by a regulatory committee set up at a later stage. See Council Decision of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission (1999/468/EC, OJ 2006 C255/4). Also see Art 127 of the draft CCCTB Directive.

⁶² See Introduction, paragraph 1.9.

⁶³ The procedure was laid down in Articles 11 and 11A of the EC Treaty and Articles 43–45 of the Treaty on the European Union. Following the ratification of the Lisbon Treaty, the procedure is now set out in Article 20 TEU and Articles 326–334 TFEU. For a comparison between the two sets of rules, see Luca Cerioni, 'Postponement of the Commission's Proposal for a CCCTB Directive: Possible Ways Forward' [2010] 2 *Bulletin for International Taxation* 98.

⁶⁴ Prior to the Lisbon Treaty, eight Member States were needed to trigger enhanced co-operation.

⁶⁵ Article 20(3) TEU and Article 330 TFEU.

⁶⁶ Article 330 TFEU.

⁶⁷ It is only when the Council has established that the objectives of such co-operation cannot be attained within a reasonable period by the Union as a whole. See Article 20(2) TEU.

⁶⁸ Article 20(4) TEU. In the same paragraph, it is stated that the acts shall not be regarded as part of the *acquis* which is to be accepted by candidate States for accession to the Union. However, it is not specified if they are part of the *acquis* for other purposes.

⁶⁹ Article 327 TFEU.

⁷⁰ See resolution of 15 January 2008 on Tax Treatment of Losses in Cross-Border Situations 2007/2144(INI), P6_TA(2008)0008, published in *Official Journal of the European Union*, C 41 E, 19 February 2009.

⁷¹ *Ibid*, paragraphs 24–25.

⁷² *Ibid*, paragraph 27.

⁷³ *Ibid*, paragraph 27.

2.2. Optionality: co-existence of domestic regimes and the CCCTB

2.2.1. It was evident in the initial technical discussion documents⁷⁴ that the Commission proceeded on the assumption that all Member States would participate in the CCCTB. The four discussion documents released by the Commission in 2010 followed the same approach.⁷⁵ So does the draft CCCTB Directive. Legally, and politically, at this stage of the process, the Commission does not acknowledge that there may be non-CCCTB Member States.⁷⁶ However, given the hostility shown by a number of Member States towards the proposal in the past,⁷⁷ it may be overambitious to expect that all Member States will agree to be included in the CCCTB zone.

2.2.2. Any proposal that is agreed seems likely, therefore, to be on the basis that the CCCTB is *optional at Member State level*; i.e. only Member States that wish to adopt it will do so. In other words, there could be non-CCCTB Member States and CCCTB Member States. The analysis in this report proceeds on that basis, even though it is widely recognised that it is legally and politically impossible for the Commission at this stage to acknowledge the possibility of non-CCCTB Member States.

2.2.3. It also seems most likely that the CCCTB will be *elective within Member States*.⁷⁸ This is because Member States are likely to maintain domestic tax rules alongside the CCCTB. The only possibility for a single uniform tax base will exist if a Member State adopts the CCCTB rules for its domestic taxpayers as well.⁷⁹

2.2.4. It is noteworthy that in its impact assessment released with the draft CCCTB Directive,⁸⁰ the Commission had compared four policy scenarios with the current 'no-action' or 'status-quo scenario'; namely, an optional Common Corporate Tax Base (CCTB, i.e. no consolidation), a compulsory CCTB, an optional CCCTB and a compulsory CCCTB.⁸¹ It was found that whilst all options would have an impact on the size and distribution of the tax base,⁸² the welfare effects of

⁷⁴ See CCCTB57, fn.20 and CCCTB/WP057annotated, fn.4.

⁷⁵ See CCCTB/RD\001, CCCTB/RD\002, CCCTB/RD\003 and CCCTB/RD\004 set out in fn.9.

⁷⁶ This was confirmed at the CCCTB conference, referred to in fn.23. Also, see comments of Michel Aujean, the former director of tax policy (TAXUD) at the Commission, reported in *Tax Analysts* on 22 February 2008: 'It has never been the intention of the European Commission to allow some member states to opt out of the system. [...] The European Commission works for the 27 member states, and examining how to deal with nonparticipating EU member states should not be part of the discussion.' See Joann M Weiner, 'Panelist Predicts Positive Future for Company Tax Reform in European Union', 49 *Tax Notes Int'l* 743 (3 March 2008); Doc 2008-3676 or 2008 WTD 36-4.

⁷⁷ Ireland, the UK and some of the new Member States (Lithuania, Latvia, Poland Slovakia, Malta and Cyprus) are likely to oppose the proposal. See EurActiv press release at <http://www.euractiv.com/en/enterprise-jobs/commission-plans-eu-company-tax-despite-opposition/article-163497> [Accessed 31 July 2010].

⁷⁸ CCCTB\WP\040\doc\en, 'Personal scope of the CCCTB' (Meeting to be held on 12 September 2006).

⁷⁹ This would have to include all domestic business entities. If it did not, then only corporate entities within the scope of the CCCTB proposal would be able to elect to follow the CCCTB. Other business vehicles would remain outside its scope.

⁸⁰ See fn.11.

⁸¹ Under all options, common rules would be established only for the calculation of the tax bases. There would be no interference with the tax rates.

⁸² The impact assessment suggested that subject to the depreciation rules to be applied, the CCTB options would lead on average and for most EU-based companies to broader tax bases than the current ones. The taxable base under the CCCTB scenarios would be around 3% lower than in the status-quo scenario. The Summary Report of the Impact Assessment (see fn.11, pp.5–7) concluded that the move from separate accounting to formula apportionment exerted a negligible effect on GDP and welfare, as it was the result of different offsetting effects: fewer incentives to shift profits and capital from high tax countries, but additional distortions in the allocation of formula factors to low tax economies. It was also concluded that loss consolidation was likely to shrink the tax bases. This might lead to certain increases in corporate tax rates to balance the government budget. The overall preferred policy option was the optional CCCTB. The Commission stated that calculations on a sample of EU multinational groups based on the Amadeus and ORBIS databases showed that, on average every year approximately 50% of non-financial and 17% of financial multinational groups in the respective samples could benefit from immediate cross-border loss compensation.

the CCCTB options, especially the optional CCCTB, were more favourable. This was due to the positive economic impact of consolidation and formula apportionment, a corollary of lower compliance costs.⁸³

2.2.5. Therefore, an elective CCCTB seems to be the chosen basis of the proposal. Companies or PEs eligible to *'elect in'* the CCCTB will be able to choose between that regime and their Member State's domestic regime – forgoing the benefit of cross-border consolidation, if unavailable domestically. By contrast, companies and PEs resident or established in Member States that *'elect out'* of the CCCTB (assuming there will be non-CCCTB Member States) will never benefit from cross-border consolidation, unless available under the domestic law of that Member State.

2.2.6. The ability to elect in and out of the CCCTB raises a number of issues for CCCTB Member States. It is very likely that the co-existence of two systems would increase compliance costs for multinationals having CCCTB and non-CCCTB group companies in a Member State. In addition, groups would have to evaluate on a regular basis whether they should operate (or continue to operate) within the CCCTB or outside of it.⁸⁴

2.2.7. The CCCTB is also very likely to increase costs for tax authorities, as they would effectively be running two systems: one for CCCTB companies and another for non-CCCTB companies. Furthermore, as shown in Part 3.5.2 below, the cross-border nature of its tax audits and the frequent interaction with other tax authorities will result in additional costs to governments collecting the consolidated tax base.⁸⁵ It is not, however, certain whether the lower compliance costs as a result of the common tax base will outweigh the compliance costs of running two systems, both from the perspective of CCCTB groups and of tax authorities.

2.2.8. The availability of an election may also lead to tax arbitrage for companies, as it would enable them to elect the less comprehensive tax base or the one with the more lenient anti-abuse rules. This could foster tax competition and tax base competition between Member States, especially if some Member States choose not to adopt the CCCTB. Member States are likely to be far less enthusiastic about a potential arbitrage-driven erosion of their tax base. Also, as some experts noted in the Commission's 12th CCCTB meeting attended by Member State experts, the situation 'would be unfair for certain taxpayers, particularly SMEs as only large companies would in practice have the resources to simulate and analyse the potential benefits that may arise from the CCCTB option'.⁸⁶ There could also be complications arising from the transition from the existing tax base to the CCCTB (exit taxes, realisation of hidden reserves etc.).⁸⁷

2.2.9. It seems, however, that the elective nature of the CCCTB is essentially a political decision of the Commission rather than a functional or economic one. If the CCCTB were to be compulsory and were to replace all domestic tax bases, then, perhaps, even fewer Member States would be ready to adopt such a drastic reform. Therefore, the elective nature of the CCCTB should be seen as a necessary

⁸³ Summary Report of the Impact Assessment, fn.11, p.7.

⁸⁴ It has been pointed out that the directors will be under a fiduciary duty to evaluate whether it is in the best interests of the group to become a CCCTB group or not. See Ernst & Young impact assessment study, fn.55, p.49. In my view, this fiduciary duty in making their election to become (or not to become) a CCCTB group is no different from the general fiduciary duty of directors in conducting their tax planning.

⁸⁵ Also see Ernst & Young impact assessment study, fn.55, pp.52–53.

⁸⁶ CCCTB/WP/63/en: 'Summary Record of the Meeting of the Common Consolidated Corporate Tax Base Working Group' (Brussels, 12 December 2007), paragraph 6.

⁸⁷ Also see Part 4.

compromise for the survival of the entire project. In its impact assessment, the Commission has also tried to argue the economic merits of this approach.⁸⁸

2.2.10. Arguably, in so far as the UK is concerned, the elective nature of the CCCTB would be an issue in deciding whether or not it should participate in the CCCTB scheme. If the UK participates in the scheme, then the aforementioned issues – compliance and administration costs of dual system, opportunities for tax arbitrage etc. – would also be issues for the UK. If the UK does not participate in the scheme, then the absence of this dual system and, as a corollary, the opportunities for tax arbitrage, as well the possible unavailability of (unrestricted and automatic)⁸⁹ cross-border loss relief may be perceived by multinationals and investors as a competitive disadvantage. This report endeavours to examine the possible repercussions for the UK in case of both eventualities.

2.3 Tax base harmonisation

2.3.1. Under the latest proposals on the tax base,⁹⁰ as well as in the draft CCCTB Directive,⁹¹ there is deliberately no formal link between the new base and IAS/IFRS, even though such a link would ‘provide a common starting point and have the advantage of allowing the base to evolve over time in line with IAS/IFRS’.⁹²

2.3.2. There are a number of reasons for this. First, IAS/IFRS are standards of financial accounting with different objectives to those that in some situations may be appropriate to tax accounts.⁹³ Also, these standards are developed by an independent non-governmental organisation⁹⁴ and change over time. Therefore, for legal certainty grounds, they are not conducive to incorporation by reference into an EU Directive.⁹⁵ Furthermore, many Member States do not currently permit the use of IAS/IFRS and the national GAAPs are the starting point for drawing financial accounts. Even if there is alignment, this does not guarantee that CCCTB Member States will interpret and apply the rules uniformly and consistently.⁹⁶ It is, therefore, uncertain whether the CCCTB will evolve towards the IFRS (and whether this is a welcome result) or whether it will have the latter as its starting point to evolve towards something independent.

⁸⁸ See Summary Report of Impact Assessment, fn.11.

⁸⁹ For the UK rules on this matter, see Part 3.2.1.

⁹⁰ CCCTB/WP057annotated, fn.4 and CCCTB57, fn.20. The recent discussion documents, as set out in fn.9, did not refer to the tax base.

⁹¹ Arts 9–53 of the draft CCCTB Directive.

⁹² CCCTB/WP057annotated, fn.4, paragraph 9. Also see an earlier Commission Communication where it was emphasised that the rules for calculating CCCTB should be self-standing and not formally linked to international accounting standards. See Communication on the progress to date and next steps towards a Common Consolidated Corporate Tax Base, COM(2006) 157, 5 April 2006. Also see Peter Essers, ‘Relationship between IAS/IFRS and the CCCTB with Respect to Provisions and Liabilities’, in Lang et al., fn.18.

⁹³ See, *inter alios*, Judith Freedman & Graeme Macdonald, ‘The Tax Base for CCCTB: The Role of Principles’, in Lang et al., fn.18; Wolfgang Schoen, ‘International Accounting Standards – A “Starting Point” for a Common European Tax Base?’ 44 [2004] *European Taxation* 426; Wolfgang Schoen, ‘The Odd Couple: A Common Future for Financial and Tax Accounting?’ 58 [2005] *Tax Law Review* 111; Irma Johanna Mosquera Valderrama, ‘The CCCTB compatible with National GAAP? What’s Next?’, 36 (2008) 8/9 *Intertax* 359.

⁹⁴ The IFRS Foundation is an independent, not-for-profit private sector organisation. The IASB (International Accounting Standards Board) is the independent standard-setting body of the IFRS Foundation. See <http://www.ifrs.org/The+organisation/IASCF+and+IASB.htm>

⁹⁵ *Ibid*, 224.

⁹⁶ An analogy has been drawn with the VAT legislation where the different interpretation and implementation of rules has led to considerable distortions in the treatment between Member States. See Ernst & Young impact assessment study, fn.55, pp.48–49. On the different interpretation of the principles of the Court of Justice, see also Christiana HJ Panayi, ‘Reverse Subsidiarity and Cross-border Loss Relief: Can Member States be left to their own devices?’ [2010] 3 *British Tax Review* 267–301.

2.3.3. Furthermore, the methodology for adjusting financial accounts to arrive at the tax base (the 'bridge') is not defined. This is, to an extent, understandable given that the linkage between financial and tax accounts is not uniform in all Member States.⁹⁷ Nor are the trends towards alignment between the two.⁹⁸ Therefore, companies will continue to prepare their financial accounts on the basis of their national GAAPs (and of IAS/IFRS if these standards are also being used, as in the UK) and these accounts will be adjusted to the new tax base by reference to domestic rules.

2.3.4. Some Member States have raised concerns that, unless the proposal sets out a methodology of reconciling financial and tax accounts, there could be an inconsistent calculation of the tax base by Member States. Furthermore, concerns have also been raised in that some Member States would potentially have to comply with at least three sets of tax accounts: the CCCTB, individual company accounts based on national GAARs and consolidated accounts based on IAS/IFRS.⁹⁹ It is regrettable that the Commission has not done any more work on the link between accounts and taxable profits.

2.3.5. In any case, as expected from a proposal that seeks to establish a common tax base, the rules on the tax base are quite extensive. It is obvious from the description of taxable income, that the profit and loss method is preferred over the tax balance sheet method.¹⁰⁰ The tax year is any 12-month accounting period.¹⁰¹ All members of a group will have the same tax year. There are yet no rules on the opening and closing tax year, or the change in a tax year.

2.3.6. The basic formulation of the taxable basis is the following: revenues less exempt revenues, deductible expenses and other deductible items.¹⁰² All these concepts are defined in the draft CCCTB Directive, which mostly follows the technical definitions of the annotated discussion document,¹⁰³ though with some refinements and deviations.

2.3.7. Instead of income, the draft CCCTB Directive uses the term 'revenues', which it defines in a much more elaborate way as 'proceeds of sales and of any other transactions, net of value added tax and other taxes and duties collected on behalf of government agencies, whether of a monetary or non-monetary nature, including proceeds from disposal of assets and rights, interest, dividends and other profits distributions, proceeds of liquidation, royalties, subsidies and grants, gifts received, compensation and ex-gratia payments. Revenues shall also include non-monetary gifts made by a taxpayer. Revenues shall not include equity raised by the taxpayer or debt repaid to it.'¹⁰⁴

⁹⁷ See Dieter Endres, *The Determination of Corporate Taxable Income in the EU Member States*, (Kluwer Law International, 2007). Also see Essers, above, fn.92, 389–398; Judith Freedman, 'Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges' (2005) 2 *eJournal Tax Research* 7; Judith Freedman, 'Financial and Tax Accounting: Transparency and "Truth"' in *Tax and Corporate Governance*, edited by Wolfgang Schön (Springer Science, 2008).

⁹⁸ As Essers points out, citing a number of studies, in some countries where there is material dependence there is a movement towards more alignment, whereas in traditional linkage countries, there is a movement towards more independence. *Ibid*, p.393. Also see Martin N. Hoogendoorn, 'Accounting and Taxation in Europe – A Comparative Overview' (1996) *The European Accounting Review*, Vol.5 Supplement 783.

⁹⁹ See Freedman (2008) fn.97; Freedman & Macdonald, fn.93.

¹⁰⁰ See Art 9 (General Principles) of the draft CCCTB Directive.

¹⁰¹ Art 9(4).

¹⁰² Art 10. This is similar to the formulation in CCCTB/WP057annotated, fn.4, paragraph 19 with the taxable basis being [Income subject to tax – Exempt income] – [Deductible expenses + Other Deductible Items].

¹⁰³ CCCTB/WP057annotated, paragraphs 22–25.

¹⁰⁴ See the definitions article, Art 4(8) of the draft CCCTB Directive. Contrast with the definition of income in CCCTB/WP057annotated, fn.4, paragraph 22: 'Income would be broadly defined to include income of any kind, whether monetary or non-monetary, including not only trading income but also proceeds from disposal of assets and rights, interest, dividends and other profit distributions, royalties, subsidies and grants, gifts, compensation and ex-gratia payments. Income would not include equity or debt raised by the taxpayer.'

2.3.8. Exempt revenue¹⁰⁵ is defined similarly though more broadly than ‘exempt income’, which was the term used under the annotated discussion document.¹⁰⁶ It encompasses subsidies directly linked to the acquisition, construction or improvement of fixed assets, subject to the depreciation rules,¹⁰⁷ and proceeds from the disposal of pooled assets, including the market value of non-monetary gifts.¹⁰⁸ Very importantly, it is now made clear that the following items are exempt revenue: received profit distributions,¹⁰⁹ proceeds from a disposal of shares¹¹⁰ and income of a permanent establishment in a third country.¹¹¹ Income of a permanent establishment in a non-CCCTB Member State is not included. The repercussions of this approach are considered in Part 5.

2.3.9. The definition of deductible expenses is also more elaborate than the one in the annotated discussion document,¹¹² as it now also includes research and development costs incurred in raising equity or debt for the purposes of the business as well as gifts to charitable bodies (subject to conditions).¹¹³ A proportional deduction may also be made in respect of the depreciation of fixed assets.¹¹⁴

2.3.10. There is also a list of non-deductible expenses¹¹⁵ similar to the non-exhaustive list of the annotated discussion document.¹¹⁶ One important exception

¹⁰⁵ Art 11.

¹⁰⁶ CCCTB/WP057annotated, fn.4, paragraph 23: ‘The following would be exempt income:

- subsidies directly linked to the acquisition, construction or improvement of a depreciable business asset;
- proceeds from the disposal of pooled assets;
- certain dividend and PE income and capital gains (see rules on participation exemption below).’

¹⁰⁷ Art 11(a) of the draft CCCTB Directive.

¹⁰⁸ Art 11(b).

¹⁰⁹ Art 11(c).

¹¹⁰ Art 11(d).

¹¹¹ Art 11(e).

¹¹² CCCTB/WP057annotated, fn.4, paragraph 24: ‘Deductible expenses would mean all expenses incurred by the taxpayer for business purposes in the production, maintenance or securing of income including costs of research and development or in the raising of equity or debt for business purposes.’

¹¹³ Art 12 of the draft CCCTB Directive. See Art 16 also, which sets out the conditions for a body to qualify as a charitable body.

¹¹⁴ See Art 13.

¹¹⁵ See Art 14(1) pursuant to which the following expenses shall be treated as non-deductible:

- ‘(a) profit distributions and repayments of equity or debt;
- (b) 50% of entertainment costs;
- (c) the transfer of retained earnings to a reserve which forms part of the equity of the company;
- (d) corporate tax;
- (e) bribes;
- (f) fines and penalties payable to a public authority for breach of any legislation;
- (g) costs incurred by a company for the purpose of deriving income which is exempt pursuant to Article 11; such costs shall be fixed at a flat rate of 5% of that income unless the taxpayer is able to demonstrate that it has incurred a lower cost;
- (h) monetary gifts and donations other than those made to charitable bodies as defined in Article 16;
- (i) [...] costs relating to the acquisition, construction or improvement of fixed assets except those relating to research and development;
- (j) taxes listed in Annex III, with the exception of excise duties imposed on energy products, alcohol and alcoholic beverages, and manufactured tobacco.’

Also see Art 14(2) and (3), which permit Member States and the Commission to deviate from some of these provisions, under certain circumstances.

¹¹⁶ CCCTB/WP057annotated, fn.4, paragraph 25: Other non-deductible expenses would include the following:

- ‘– profit distributions, repayments of equity or debt or any payment to or expenditure incurred for the benefit of shareholders or persons related thereto,
- expenses relating to assets treated as non-business (see below),
- 50% of entertainment and representation costs,
- appropriation of retained earnings which forms a part of equity (reserves),
- corporate income tax,
- bribes,
- fines and penalties payable to a public authority for breach of any legislation,
- management costs to the extent to which they are incurred by a company in deriving dividend and PE income and capital gains which are exempt income,
- monetary gifts and donations except to charitable bodies meeting common criteria to be established under the comitology procedure,
- costs relating to the acquisition, construction or improvement of fixed assets except those relating to research and development.’

is that financing costs are no longer *prima facie* deductible.¹¹⁷ Now, the *prima facie* rule appears to be that costs incurred by a company for the purpose of deriving exempt revenue are non-deductible.¹¹⁸ Such non-deductible costs shall be fixed at a flat rate of 5% of that (exempt) income unless the taxpayer is able to demonstrate that it has incurred a lower cost.¹¹⁹ Another important addition to the draft CCCTB Directive is that expenditure incurred for the benefit of shareholders (and their relatives)¹²⁰ are not deductible expenses to the extent that such benefits would not have been granted to an independent third party.

2.3.11. Broadly, assets used in the business for more than 12 months are fixed assets.¹²¹ Fixed assets include financial assets.¹²² Income and expenses are recognised on an accruals basis in the tax year to which they relate.¹²³ The draft CCCTB Directive contains detailed rules for timing and quantification of revenues and deductible expenses,¹²⁴ including rules for hedging transactions,¹²⁵ long-term contracts¹²⁶ and bad relief rules.¹²⁷

2.3.12. For the purposes of calculating the tax base, transactions shall be measured by reference, *inter alia*, to monetary consideration, market price (where there is no monetary consideration or only part of it is monetary consideration) and fair value of financial assets and liabilities held for trading.¹²⁸ There is no longer specific reference to arm's length pricing for transactions between related parties as there was in the annotated discussion document,¹²⁹ but the preamble to the draft Directive stipulates that.¹³⁰ The draft CCCTB Directive also provides for adjustment of pricing in relations between associated enterprises.¹³¹

2.3.13. Moreover, the draft Directive contains detailed rules on depreciation. It provides for the recording of acquisition, construction or improvement costs in a fixed asset register.¹³² The depreciation base comprises of any cost directly connected with the acquisition, construction or improvement of a fixed asset, reduced by subsidies.¹³³ There are rules on who is entitled to depreciate and how

The same paragraph also stipulates that 'all expenditure on staff, including directors, would be treated as a business expenditure on the assumption that Member States would subject, if deemed necessary, any private element/benefits in kind to personal income taxation. Similar considerations apply to assets purchased wholly or partly for the benefit of an employee'.

¹¹⁷ This was the suggestion in fn.13 of CCCTB/WP057annotated, p.10, which stated that '[i]nterest on, and costs of loans taken up for the acquisition of shareholdings from which the exempt distribution of profits is derived would not be a non-deductible expense – i.e. would in principle be deductible.' This was a very attractive feature of the CCCTB but it was expected to be qualified by rules disallowing interest relief.

¹¹⁸ Art 14(1)(g).

¹¹⁹ *Ibid.* It is surprising that the taxpayer has the onus of demonstrating that it has incurred a lower cost, as it is the tax authorities who would have an interest to demonstrate that.

¹²⁰ Art 15 includes benefits granted to a shareholder who is an individual, his spouse, lineal ascendant or descendant or associated enterprises, holding a direct or indirect participation in the control, capital or management of the taxpayer, as referred to in Article 78.

¹²¹ See full definition of 'fixed assets' in Art 4(14).

¹²² *Ibid.* Financial assets are defined in Art 4(15) as shares in affiliated undertakings, loans to affiliated undertakings, participating interests, loans to undertakings with which the company is linked by virtue of participating interests, investments held as fixed assets, other loans, and own shares to the extent that national law permits their being shown in the balance sheet. There are two further sub-categories of fixed assets: long-life fixed tangible assets and second-hand assets, defined in Art 4(16) and (17) respectively.

¹²³ Art 27 of draft CCCTB Directive. Also see CCCTB/WP057annotated, paragraph 31.

¹²⁴ Arts 17–31 of draft CCCTB Directive (Chapter V).

¹²⁵ Art 28.

¹²⁶ Art 24.

¹²⁷ Art 27. Also see CCCTB/WP057annotated, fn.4, paragraphs 32–42.

¹²⁸ See valuation rules in Art 22 of draft CCCTB Directive. For a description of financial assets and liabilities held for trading see Art 23.

¹²⁹ CCCTB/WP057annotated, fn.4, paragraph 43.

¹³⁰ See paragraph 19 of the preamble to the draft CCCTB Directive, which states that 'Transactions between a taxpayer and an associated enterprise which is not a member of the same group should be subject to pricing adjustments in line with the "arm's length" principle, which is a generally applied criterion'.

¹³¹ See Art 79, also referred to in Part 2.5.

¹³² Art 32.

¹³³ Art 33(1), (3).

the economic owner is to be identified.¹³⁴ Generally, long-term assets such as buildings would be depreciated on an individual basis whereas short to medium term assets would be pooled.¹³⁵ There are further detailed rules on the depreciation of certain assets. Two types of assets are not subject to depreciation; namely, fixed tangible assets not subject to wear and tear and obsolescence (e.g. land, fine art, antiques, or jewellery) and financial assets.¹³⁶ There are also provisions for exceptional depreciation.¹³⁷

2.3.14. Given that the regime is likely to be optional,¹³⁸ Member States would have to decide whether to adopt the CCCTB *at all*. If they do adopt it, then they would have to decide whether it will be their sole tax base or whether they will retain their own tax base but allow companies to *elect in* the CCCTB. Additionally, Member States would have to decide whether to adopt the CCCTB only for the entities listed in the proposal or extend it to other entities as well.

2.3.15. In deciding whether to adopt the CCCTB even as an option, the UK ought to compare the breadth of the CCCTB with that of the UK tax base. Also, it ought to consider how prescriptive the CCCTB is and the extent to which the rules would be subject to changes through the Comitology procedure.¹³⁹ Furthermore, the UK would have to factor in the transitional costs of moving, even partially, to the new tax base (e.g. new reliefs, more lenient rules for depreciation, remaining balancing charges etc.). This is in addition to the problems mentioned above, such as the expense of administering two tax bases, opportunities for tax arbitrage etc.¹⁴⁰ Some of these issues are mentioned again in Part 4 of this report.

2.3.16. If the UK decides not to adopt the CCCTB even as an elective tax base, then it would have to consider whether UK holding companies suffer a competitive disadvantage by complying with the UK tax base rather than the CCCTB. The UK may have to adjust elements of its tax base (e.g. deductions, capital allowances) to ensure that it remains competitive. Therefore, a comprehensive comparison of the UK rules and the CCCTB is imperative for the UK to assess the possible disadvantages from opting out of the proposal. A brief comparison of some of these elements is found in Parts 3 and 4 of this report.

2.3.17. In a press release issued on the date of publication of the draft CCCTB Directive, the Commission noted that for most Member States, the new tax base would be broader than the existing national tax base. On average, the Commission estimated that the common tax base would be broader by 7.9%.¹⁴¹ However, as pointed out in the impact assessment, as well as in other studies, within the CCCTB, the tax base is likely to be reduced as a result of the opportunities arising for cross-border consolidation.¹⁴²

¹³⁴ Art 34.

¹³⁵ See Arts 36 and 39. Also see CCCTB/WP057annotated, fn.4, paragraph 56.

¹³⁶ Art 40.

¹³⁷ Art 41.

¹³⁸ See Part 2.2.

¹³⁹ See Art 127 of the draft Directive, which sets out the power of the Commission to adopt delegated acts for an indeterminate period of time.

¹⁴⁰ See Part 2.2.

¹⁴¹ Estonia was excluded as the country has a distribution tax only applicable on paid out dividends and a tax base definition is not needed. MEMO/11/171, fn.13, p.6.

¹⁴² See Summary Report of the Impact Assessment, fn.11, p.7; PWC report, 'Impact of Corporate Income Tax Reforms at the EU Level on European Business Taxpayers – Report on the impact on taxable profits', 9 July 2008 (PWC Taxable Profits Report); Deloitte, Final report, 'Expert Study on the Corporate Tax Compliance Costs for Businesses going EU Cross Border – Comparison under the current regime, the CCTB and the CCCTB regime', EU Project on Corporate Tax Compliance Cost (13 November 2009), pp.13, 20.

2.4 Consolidation and cross-border loss relief

2.4.1. A central feature of the CCCTB and perhaps the core attraction is cross-border consolidation. Profits and losses of qualifying subsidiaries of the CCCTB group (and the PEs of such qualifying subsidiaries) would be consolidated, notwithstanding that they are resident or established in different Member States.¹⁴³ As a result of this pooling of tax bases, losses incurred by one consolidated member company will be offset against profits of another consolidated group company, regardless of their Member State of residence or establishment. Consolidation under the CCCTB is, thus, expected to address the general unavailability of cross-border loss relief, whether within the same company or between group companies. The Court of Justice has dealt with this issue but not very satisfactorily or consistently.

2.4.2. *Marks & Spencer*¹⁴⁴ was the first case to address the question of cross-border loss relief between group companies. Under the UK tax legislation applicable at the time,¹⁴⁵ group relief could only be granted for losses considered to be within the scope of UK taxation. This meant that losses incurred by a UK branch¹⁴⁶ of a non-resident company could be surrendered to another group company for offset against its UK taxable profits. Also, losses incurred by a UK group company could be surrendered to the UK branch of a non-resident company for offset against any UK profits. Therefore, a non-resident group company without a UK branch could not surrender its losses to a UK group company.

2.4.3. In *Marks & Spencer*, the condition that the surrendering and claimant companies be resident or carry on an economic activity in the UK was challenged. The Court of Justice found that the non-availability of group relief for losses from foreign subsidiaries restricted the freedom of establishment of the UK parent companies. This restriction could be justified on the following three grounds, taken together:¹⁴⁷ the need to preserve the allocation of taxing rights between Member States,¹⁴⁸ the prevention of double relief of losses¹⁴⁹ and the risk of tax avoidance.¹⁵⁰

¹⁴³ See Arts 54–59 of the draft CCCTB Directive.

¹⁴⁴ Case C-446/03 *Marks & Spencer* [2005] ECR I-10837. See, for example, Mark Persoff, 'Marks & Spencer: More Questions than Answers' [2005] *British Tax Review* 260; S Douma & C Naumburg, 'Marks & Spencer: Are National Tax Systems Eclairé?' [2006] *European Taxation* 431; Malcolm Gammie, 'The Impact of the Marks & Spencer Case on US-European Planning' (2005) 33 *Intertax* 485; Hans van den Hurk, 'Cross-Border Loss Compensation: The ECJ's Decision in Marks & Spencer and How It was Misinterpreted in the Netherlands' [2006] *Bulletin for International Taxation* 178; Frans Vanistendael, 'The ECJ at the Crossroads: Balancing Tax Sovereignty against the Imperatives of the Single Market' [2006] 10 *European Taxation* 413; Timothy Lyons, 'Marks & Spencer: Something for Everyone?' [2006] *British Tax Review* 12; Michael Lang, 'Marks and Spencer – More Questions than Answers: An Analysis of the Opinion delivered by Advocate General Maduro' (2005) 14 *EC Tax Review* 95; Michael Lang, 'The Marks & Spencer Case: The Open Issues Following the ECJ's Final Word' [2006] *European Taxation* 54; Mathieu Isenbaert, 'M&S Judgment: The ECJ Caught between a Rock and a Hard Place' [2006] 1 *EC Tax Review* 10; Philip Martin, 'The Marks & Spencer EU Group Relief Case: A Rebuttal of the "Taxing Jurisdiction Argument"' (2005) 14 *EC Tax Review* 61; Tom O'Shea, '*Marks & Spencer v. Halsey (HM Inspector of Taxes)*: Restrictions, Justification and Proportionality' [2006] 2 *EC Tax Review* 66; Gerrard TK Meussen, 'The Marks & Spencer Case: The Final Countdown Has Begun' [2005] *European Taxation* 160–163.

¹⁴⁵ Formerly found in sections 402–413 Income and Corporation Taxes Act 1988.

¹⁴⁶ In this report, the terms 'branch' and 'permanent establishment' are used interchangeably.

¹⁴⁷ After setting out these grounds, the Court of Justice stated that they are to be 'taken together'. *Ibid*, paragraph 51. In subsequent cases, it was held that this was not a cumulative requirement. See, for example, Case C-470/04 N case [2006] ECR I-7409, paragraph 42; Case C-231/05 *Oy AA* case, paragraphs 51–60 and Case C-379/05 *Amurta* [2007] ECR I-9569, paragraphs 57–59. However, in the recent case of Case C-311/08 *SGL* [2009] ECR I-0000, the Court has again held that the two justifications of balanced allocation of taxing powers and prevention of tax avoidance are to be taken together. See paragraphs 69–70.

¹⁴⁸ *Ibid*, paragraphs 43–46.

¹⁴⁹ *Ibid*, paragraphs 47–48.

¹⁵⁰ *Ibid*, paragraphs 49–50.

2.4.4. However, for the restriction to be justified, it had to be proportional. In order to assess the proportionality of the restrictive measure, the Court of Justice took into account whether the non-resident subsidiary had exhausted all possibilities for relief available in its Member State of residence. According to the Court, the availability of carry back, current year relief against other local profits, or carry forward, either by the subsidiary or a third party to which those losses were transferred or sold, meant that not all possibilities for relief had been exhausted.¹⁵¹ It was up to the referring court to decide whether this was the case. The follow-up to the *Marks & Spencer* case in the UK is examined below.¹⁵²

2.4.5. The judgment, whilst ground-breaking, left a number of important issues unresolved.¹⁵³ At the time of the judgment, it was unclear whether the *Marks & Spencer* reasoning would apply uniformly across all types of loss relief regimes (e.g. consolidation regimes, profit contribution regimes)¹⁵⁴ or whether there would be variations. Subsequent cases suggest not, though, as is shown below, these do not seem to be underpinned by cogent justification. It was also questionable whether the principles set out in the *Marks & Spencer* judgment were restricted to group relief arrangements or whether they could be extended to situations involving foreign permanent establishments.¹⁵⁵ Another issue criticised was the Court of Justice's focus on terminal losses. The Court did not consider the cash-flow disadvantage resulting from the unavailability of relief for non-terminal losses. In that way, the Court avoided having to determine whether a system of recapturing losses ought to be applied. Being terminal losses, they could never be recaptured. The ambiguities of the judgment are reflected in the variable ways in which it was received in subsequent cases.

2.4.6. In *Oy AA*,¹⁵⁶ even though under the Finnish profit contribution regime the deductibility of an intra-group transfer was dependent on both the contributor

¹⁵¹ The salient paragraph of this decision is paragraph 55, where the Court of Justice stated that 'the restrictive measure at issue in the main proceedings goes beyond what is necessary to attain the essential part of the objectives pursued where:

- the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods, if necessary by transferring those losses to a third party or by offsetting the losses against the profits made by the subsidiary in previous periods, and
- there is no possibility for the foreign subsidiary's losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party.'

¹⁵² See Part 3.2.1.

¹⁵³ See HJI Panayi (2010), fn.96.

¹⁵⁴ On the variety of tax rules dealing with groups, see the results of a survey in Dieter Endres, 'The Concept of Group Taxation: A Global Overview', 31 [2003] 10 *Intertax* 349. Also see, *inter alios*, Yoshihiro Masui, 'General Report on Group Taxation' in IFA (ed.), vol.89b (2004) *Cahiers de Droit Fiscal International* 21; Ioanna Mitroyanni, *Integration Approaches to Group Taxation in European Internal Market* (Kluwer, 2008), pp.122–126; Savina Princen & Marcel Gerard, 'International Tax Consolidation in the European Union: Evidence of Heterogeneity' [2008] 4 *European Taxation* 174; Julien Saiac, 'Deduction of Losses Incurred in Another Member State by a Non-resident Subsidiary following Marks & Spencer' [2007] 12 *European Taxation* 550.

¹⁵⁵ Contrary to the Advocate General's opinion, the Court of Justice focused on a comparison between a UK parent with a resident subsidiary and a UK parent with a non-resident subsidiary. Advocate General Maduro had argued that a subsidiary and a permanent establishment were not in a comparable situation because the income of foreign permanent establishments of UK companies could be consolidated whereas the income of foreign subsidiaries, being independent legal and fiscal entities, could not be consolidated. Case C-446/03 *Marks & Spencer*, paragraph 48 (Opinion). The Court of Justice saw no need to compare the tax treatment of a foreign subsidiary and a foreign permanent establishment. In fact, this was not even mentioned. The end result was the same because the Advocate General had concluded that permanent establishments and subsidiaries were not in a comparable situation under UK tax law.

¹⁵⁶ Case C-231/05 *Oy AA* [2007] ECR I-6373. See Marjaana Helminen, 'Freedom of Establishment and *Oy AA*' [2007] 11 *European Taxation* 490; Ben J Kiekebeld & Daniel S Smit, 'Cross-Border Loss Relief in the EU: Uncertainty Remains after *Oy AA*', 48 *Tax Notes Int'l* 1149 (17 December 2007), 2007 WTD 247-15; Audrey Nutt, 'ECJ Permits Discriminatory Treatment in *Oy AA*' (2007) WTD 141-2; Gianluigi Bizioli, 'Balancing the

and the recipient being resident companies,¹⁵⁷ this was considered to be compatible with freedom of establishment. Here, a Finnish resident company, Oy AA, could not deduct a contribution to its UK resident parent company. The Court of Justice found that although the Finnish rule restricted the freedom of establishment, the restriction was justified on the basis of safeguarding the balanced allocation of taxing powers between Member States¹⁵⁸ and the prevention of tax avoidance, taken together.¹⁵⁹ Rather surprisingly, however, the Court of Justice found that ‘taken as a whole’¹⁶⁰ the Finnish regime was proportional, even though it was not specifically designed to prevent purely artificial arrangements. And, equally surprisingly, the Court refrained from explaining why the *Marks & Spencer* exhaustion of possibilities test was not to be considered.

2.4.7. In *X Holding*,¹⁶¹ the Dutch fiscal unity regime was challenged and more specifically the provision that prevented a Dutch parent company from forming a consolidated group with non-resident subsidiaries.¹⁶² Under the Dutch regime, resident group companies could be treated as a fiscal unity¹⁶³ if the parent company owned at least 95% of the shares in the subsidiary and only for overlapping accounting periods. Non-resident subsidiaries could not be included in a fiscal unity unless they had a Dutch permanent establishment to which the shares in the subsidiary were attributed. Here, a Dutch parent, X Holding BV, was prevented from forming a fiscal unity with its wholly owned Belgian subsidiary, F NV, as the latter did not have a Dutch permanent establishment.

2.4.8. In a preliminary reference, the Court of Justice found that the regime restricted freedom of establishment but the restriction was justified.¹⁶⁴ The Court concentrated on the fact that this was an optional regime. The optional nature of the arrangement, combined with the ability to alter the fiscal unity on a yearly

Fundamental Freedoms and Tax Sovereignty: Some Thoughts on Recent ECJ Case Law on Direct Taxation’ [2008] 3 *European Taxation* 133.

¹⁵⁷ The parent company also had to hold at least 90% of the shares of the subsidiary or both had to be held by a joint parent company which held 90% in these companies.

¹⁵⁸ Case C-231/05 *Oy AA*, above fn.156, paragraph 56.

¹⁵⁹ *Ibid*, paragraphs 58–59.

¹⁶⁰ *Ibid*, paragraph 63.

¹⁶¹ Case C-337/08 *X Holding BV* [2010] ECR I-000. This case was preceded by Case C-418/07 *Société Papillon* [2008] ECR I-0000, dealing with the French consolidation regime. Here, a French parent company was prevented from including in its consolidated tax group resident sub-subsidiaries that were indirectly held through a Dutch company. In a preliminary reference by the Conseil d’Etat, the Court of Justice found the restriction to be contrary to freedom of establishment. Although it was justified by the need to preserve the coherence of the French group tax system, the restriction was found to be disproportional. This was not a representative cross-border case on consolidation systems as the parent company was not asking to consolidate with the intermediary Dutch company. Rather, it challenged the French rules, which prevented it from forming a consolidated group with its other French sub-subsidiaries, as a result of being held by a non-resident company. Therefore, there was no question of foreign losses being offset by French taxable profits. For general commentary, see Jerome Delauriere, ‘The Papillon Decision, Upcoming French Tax Group Reform’, *Tax Notes International* 49, 903 (9 March 2009); Pierre-Henri Durand & Yves Rutschmann, ‘The Papillon Case: A First Step Toward a New Era in European Tax Treatment of Groups?’ [2009] 3 *EC Tax Review* 122; Ambroise Bricet, Marie-Pierre Hôo & Mathieu Gautier, ‘French Group Consolidation Regime Violates EC Treaty, ECJ rules’ (2008 WTD 235-6).

¹⁶² Case C-337/08 *X Holding*, fn.161. The Court of Justice delivered its judgment on 25 February 2010. See Paulus Merks, ‘ECJ Accepts Dutch Restriction of Cross-border Loss Relief’ (2010 WTD 39-2). For an interesting discussion on the fiscal unity regime, pre-dating the emergence of this case, see Hans van den Hurk, ‘Cross-border Loss Compensation – The ECJ’s Decision in Marks & Spencer and How it was Misinterpreted in the Netherlands’ [2006] 5 *Bulletin for International Taxation* 178.

¹⁶³ When a fiscal unity was formed, a subsidiary was effectively treated as a permanent establishment of the parent company. The profits and losses of companies within the fiscal unity were calculated on a fully consolidated basis, inter-company transactions were ignored and only one corporate income tax return was filed for the entire entity.

¹⁶⁴ *Ibid*, paragraph 33. The Advocate General had also questioned whether a justification on the basis of preventing the double use of losses and preventing tax avoidance was also applicable. However, she did not consider it necessary to give a definitive opinion on these, as there was no need for a separate ground of justification in addition to the safeguarding of the allocation of the power to impose taxes. *Ibid*, paragraphs 70–72 (Opinion).

basis,¹⁶⁵ raised concerns that the tax base of the unity would be manipulated. The parent company could choose to consolidate with loss-making foreign subsidiaries in one year and exclude them from the fiscal unity in a following year when they become profitable. Vice-versa, the parent company could choose to exclude profitable foreign subsidiaries from the fiscal unity in one year and include them in a following year when they are making losses. Therefore, the Court of Justice thought that the restriction was justified on the basis of safeguarding the allocation of the power to impose taxes between Member States.

2.4.9. The restriction did not go beyond what was necessary to achieve this objective.¹⁶⁶ Even though non-resident subsidiaries were completely excluded from a fiscal unity, this did not render the regime disproportionate. The fact that a more proportional recovery arrangement applied to foreign permanent establishments was not a relevant consideration because permanent establishments and subsidiaries were not in a comparable situation having regard to the allocation of the power to impose taxes.¹⁶⁷ Hence, the Netherlands was under no obligation to extend this advantage to foreign subsidiaries.¹⁶⁸

2.4.10. These cases suggest that the Court of Justice has not applied the *Marks & Spencer* exhaustion of possibilities test in a very consistent or theoretically coherent way. They also suggest that the Court is unwilling to impose judicially an obligation on Member States to extend their loss relief regimes to cross-border situations. This appears to be confirmed in the case law on losses of overseas permanent establishments which developed in a similarly constrained way. So far, the Court of Justice appears to be reluctant to demand relief for overseas permanent establishment losses,¹⁶⁹ out of respect for the allocation of taxing powers between the Member States concerned.

2.4.11. In *Lidl Belgium*,¹⁷⁰ the German rules, which prevented losses incurred by a foreign branch of a German company (here, a Luxembourg branch) to be set off against the profits of the company,¹⁷¹ were found to be compatible with EU law. Although there was a restriction to freedom of establishment,¹⁷² this restriction could be justified on the basis of two of the *Marks & Spencer* grounds:

¹⁶⁵ *Ibid*, paragraph 32.

¹⁶⁶ *Ibid*, paragraph 42.

¹⁶⁷ *Ibid*, paragraphs 36–38.

¹⁶⁸ *Ibid*.

¹⁶⁹ In Case C-293/06 *Deutsche Shell* [2008] ECR I-1129, the Court of Justice found the German legislation, which prohibited currency losses of an Italian permanent establishment to be set off against the profits of the German head office, to be incompatible with freedom of establishment. However, here there was no cross-border transfer of losses. The currency loss was not a loss that could ever be suffered by the permanent establishment – it was a loss of the head office. As such, to exclude it from the tax base of the head office when it could never be deducted in the Member State of the permanent establishment was an unjustifiable restriction to the freedom of establishment. Therefore, *Deutsche Shell* is not a case dealing with relief for losses of an overseas branch as it technically deals with the losses of the head office.

¹⁷⁰ Case C-414/06 *Lidl Belgium GmbH & Co KG/Finanzamt Heilbronn* [2008] ECR I-3601. Wolfgang Kessler and Rolf Eicke, 'Lidl Belgium: Revisiting Marks & Spencer on the Branch Level' 49 *Tax Notes International* 1131 (31 March 2008); Igran Mkrtchyan, 'In Search of Ariadne's Thread: Permanent Establishments and Losses in the European Union' [2009] 12 *Bulletin for International Taxation* 586; Werner Haslehner, 'Cross-Border Loss Relief for Permanent Establishments under EC Law' [2010] 1 *Bulletin for International Taxation* 33; Jerome Monsenego, 'Relieving Double Taxation: A Look at Lidl Belgium' 50 *Tax Notes International* 409 (5 May 2008); Wolfgang Kessler & Rolf Eicke, 'Cross-border Loss Transfer after Lidl Belgium' 50 *Tax Notes International* 643 (26 May 2008); 'Opinion Statement of the CFE Task Force on ECJ Cases on the Judgment in the case of *Lidl Belgium GmbH & Co KG v. Finanzamt Heilbronn*' (Case C-414/06) [2008] 11 *European Taxation* 590. A similar case which dealt with a non-EU branch was dismissed by the Court of Justice by order as not falling within the protective scope of freedom of establishment: Case C-415/06 *Stahlwerk Ergste Westig GmbH/Finanzamt Düsseldorf-Mettmann* [2007] ECR I-152.

¹⁷¹ This was because under the tax treaties with Luxembourg, Germany exempted both profits and losses of foreign branches. In other words, both profits and losses of a Luxembourg branch were removed from the taxable base of the German company.

¹⁷² *Ibid*, paragraphs 23–25.

preservation of allocation of taxing powers and prevention of double relief of losses.¹⁷³ The restriction was also sufficiently targeted and proportional.¹⁷⁴ The Court of Justice found that the *Marks & Spencer* test of exhaustion of possibilities¹⁷⁵ had not been satisfied. This was because the branch losses were *not* terminal losses. The Luxembourg tax legislation provided for the possibility of deducting the branch losses in future tax years.¹⁷⁶ Therefore, there was no need for an immediate deduction of losses and future recapture.

2.4.12. The *Krankenheim* case¹⁷⁷ was decided in similar fashion.¹⁷⁸

2.4.13. One may, therefore, conclude that cross-border loss relief does not appear to be readily available following recent judgments of the Court of Justice. It is still unclear whether the exhaustion of possibilities/terminal loss test is to be applied to other loss relief regimes or whether it is limited to group relief rules akin to the UK's regime. If the former, then recent case law does not confirm it. If the latter, then this is arguably unfair. Even in scenarios very similar to *Marks & Spencer*, the exhaustion of possibilities test may not be easy to apply – nor uniformly.¹⁷⁹ The consolidation aspect of the CCCTB will be useful in that regard.

2.4.14. Under CCCTB57, consolidation and, as a corollary, cross-border group relief and elimination of intra-group transactions, is only available to *consolidated* group members; i.e. members of the same CCCTB group that are 75% group members (in terms of voting rights).¹⁸⁰ Also, consolidation is not available to affiliated companies (or permanent establishments) in third countries, unless and to the extent that they have a PE in a CCCTB jurisdiction. By analogy, consolidation will also *not* be available in Member States that opt out of the CCCTB, even though the Commission does not acknowledge this possibility.

2.4.15. Case law on cross-border loss relief will, therefore, *still* be relevant for any Member States that opt out of the CCCTB. For example, if the CCCTB consolidated group incurs an overall loss and its member in a non-CCCTB Member State is profitable, then the *Mark & Spencer's* principle (assuming it has not been indirectly overruled by the case law) may be applicable. This means that the non-CCCTB Member State may be required to allow the offsetting of the consolidated group's losses against the profits of its non-consolidated member.

2.4.16. Arguably, this seems as a more remote possibility than at present because consolidation would operate first to offset gains and losses within the consolidated group so that it is only when the consolidated group had an overall loss that it would look to the profits of the non-CCCTB affiliate. Furthermore, if the losses can be carried forward by the consolidated group, then the non-CCCTB

¹⁷³ *Ibid*, paragraphs 30–37. Here, there was no need for all three justifications to be applicable. *Ibid*, paragraphs 40–41. Cf. with *SGI* case, fn.147 and the commentary therein.

¹⁷⁴ *Ibid*, paragraph 43.

¹⁷⁵ That is, paragraph 55 of the *Marks & Spencer* judgment.

¹⁷⁶ The branch had, in fact, benefited from this provision in 2003, when it generated profits. See paragraphs 49–50.

¹⁷⁷ Case C-157/07 *Finanzamt für Körperschaften III in Berlin v. Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* [2008] ECR I-8061. For commentary, see Gerrard TK Meussen, 'The ECJ's Judgment in *Krankenheim* – The Last Piece in the Cross-border Loss Relief Puzzle?' [2009] 7 *European Taxation* 361; Igran Mkrtchyan, 'In Search of Ariadne's Thread: Permanent Establishments and Losses in the European Union' 12 [2009] *Bulletin for International Taxation* 586; Werner Haslehner, 'Cross-Border Loss Relief for Permanent Establishments under EC Law' [2010] 1 *Bulletin for International Taxation* 33.

¹⁷⁸ The case was decided by order of the Court of Justice on 23 October 2008.

¹⁷⁹ Also see HJI Panayi (2010) fn.153.

¹⁸⁰ For the refined test following CCCTB/RD\001, fn.9, see analysis in Part 2.1 above.

Member State may be not be required to give any relief.¹⁸¹ As explained in Part 3.2.3, within a CCCTB group remaining losses are carried forward indefinitely – as long as the group exists. Therefore, to an extent, they are insulated from other non-CCCTB group companies and may not be transferrable for relief (e.g. upstream or across to a profitable non-CCCTB EU group company) in circumstances where the *Marks & Spencer* principle may have applied.

2.4.17. Moreover, the treatment of cross-border losses will not be reciprocal. For example, a UK parent/affiliate would not qualify for automatic consolidation if the UK is outside of the CCCTB area and may only be able to *get* relief from a profitable CCCTB group due to its non-consolidated status if the strict conditions established in *Marks & Spencer* (again, assuming this remains the leading authority) are satisfied.¹⁸² The draft CCCTB Directive does not seem to preclude the offsetting of a negative non-CCCTB (but EU) tax base¹⁸³ against the positive tax base of the CCCTB group. Nor does it allow it though. Of course, this scenario cannot arise under the Commission's CCCTB proposal because it is based on the premise that all Member States would be CCCTB Member States.

2.4.18. Therefore, whenever the threshold requirements for consolidation are met, the CCCTB rules are meant to replace the Court's case law on cross-border group relief. In other words, this case law would be made redundant, if *all* Member States are included in the CCCTB. On the assumption that there will be non-CCCTB Member States, however, there would remain the possibility that existing case law might require the consolidated group to give relief for losses of group companies within those States, notwithstanding the more limited scope for loss relief in the other direction.¹⁸⁴

2.4.19. Much will depend on how the duty of enhanced co-operation is interpreted, not just from the perspective of non-CCCTB Member States but also that of CCCTB Member States. Mainly, it will depend on whether the group relief case law of the Court of Justice will apply to the consolidated CCCTB tax base. There is no reason why it should not apply. In fact, if it does not, it may mean that losses incurred by non-CCCTB EU subsidiaries of a CCCTB group, itself owned by a non-CCCTB EU parent, will be left stranded and may not even be left to benefit from the *Marks & Spencer* principle and the case law of the Court of Justice.

2.4.20. Other benefits of consolidation, such as the elimination of intra-group transactions are examined below.

2.5 Consolidation and other benefits

2.5.1. Another important benefit arising from cross-border consolidation is the elimination of intra-group transactions for companies participating in the CCCTB group.¹⁸⁵ Under the Directive, for the purpose of determining whether there is an

¹⁸¹ Under the last draft of the CCCTB, when consolidation results in an overall loss for the group, this loss would be carried forward at group level and set off against future consolidated profits, before the net profits are shared out. It is only when the group terminates that unrelieved losses are attributed to companies belonging to the consolidated group at the moment of termination (and potentially become available for surrender). Therefore, losses of a consolidated group may not, in fact, be 'surrenderable' to the non-CCCTB affiliate, unless the CCCTB group is wound up. See CCCTB57, fn.20, paragraphs 101–104.

¹⁸² Case C-446/03 *Marks & Spencer*, fn.144, paragraph 55.

¹⁸³ Of a subsidiary akin to a qualifying subsidiary.

¹⁸⁴ If a high threshold is set for consolidation there may be similar issues within a Member State that adopts a lower threshold for its domestic consolidation regime.

¹⁸⁵ Art 59(1) of the draft CCCTB Directive. For an excellent analysis, see Ioanna Mitroyanni & Chiara Putzolu, 'CCCTB and Business Reorganizations: The Common Consolidated Corporate Tax Base and Business

intra-group transaction, both parties to the transaction must be group members at the time that the transaction is effected and the associated revenues and expenses fall to be recognised.¹⁸⁶ Groups have to apply ‘a consistent and adequately documented method for recording intra-group transactions’.¹⁸⁷ The method for recording intra-group transactions will enable all intra-group transfers and sales to be identified at the lower of cost and value for tax purposes.¹⁸⁸ No withholding taxes or other source taxation will be charged on transactions between members of a group.¹⁸⁹

2.5.2. The elimination of intra-group transactions would help remove the transfer pricing issues arising from separate accounting and create compliance savings. The complex OECD Guidelines on Transfer Pricing would cease to be relevant for transactions between consolidated group members, as there will be no need to maintain documentation and research comparables to show arm’s-length transfer pricing.¹⁹⁰ The increased compliance savings were also referred to in the Commission’s impact assessment.¹⁹¹

2.5.3. There are, however, limitations to these benefits, as transfer pricing will continue to be relevant in some circumstances.

2.5.4. First, associated enterprises¹⁹² that are not part of the consolidated group will have to apply transfer pricing rules. In a general way, the draft CCCTB Directive stipulates that ‘[w]here conditions are made or imposed in relations between associated enterprises which differ from those that would be made between independent enterprises, then any income which would, but for those conditions, have accrued to the taxpayer, but, by reason of those conditions, has not so accrued, shall be included in the income of that taxpayer and taxed accordingly’.¹⁹³ The CCCTB rules largely follow Article 9 of the OECD Model,¹⁹⁴ even though no explicit reference is made to it.¹⁹⁵

Reorganizations’ 37 [2009] 8/9 *Intertax* 436–448; Daniela Hohenwarter, ‘Moving In and Out of a Group’, in Lang et al. (2008) fn.18.

¹⁸⁶ Art 59(2).

¹⁸⁷ Art 59(3). They may change the method only for valid commercial reasons, at the beginning of a tax year.

¹⁸⁸ Art 59(4).

¹⁸⁹ Art 60.

¹⁹⁰ Transfer pricing issues may also be relevant to the allocation of the tax base between participating Member States, depending on the detail of the allocation formula adopted. Transfer pricing issues in this context, however, are likely to be much less important than they are at present.

¹⁹¹ See analysis in Part 1.8. Also see PWC Taxable Profits Report and Deloitte Study, referred to in fn.142.

¹⁹² Initially, the proposal referred to ‘related’ companies. CCCTB57 described related companies as companies whose voting rights were owned by more than 20%: CCCTB57, fn.20, paragraph 78. This test was later on refined by the more elaborate test of associated enterprises, which was streamlined with the OECD test: see CCCTB/RD\003, fn.9, paragraphs 16–21. It has now been replicated in Art 78 of the draft CCCTB Directive.

¹⁹³ Art 79 of the draft CCCTB Directive.

¹⁹⁴ Under Art 78(1), which follows the amendments of CCCTB/RD\003 (see paras 18–21), the following structures create associated enterprises:

A taxpayer participates directly or indirectly in the management or control or capital of a non-taxpayer or a taxpayer not in the same group.

The same persons participate directly or indirectly in the management or control or capital of a taxpayer and a non-taxpayer or a taxpayer not in the same group.

The relation between a head office and its permanent establishments.

Under Art 78(2), it is stated that the threshold for control is a holding exceeding 20% of the voting rights. The threshold for participation in the capital is a participation exceeding 20% of ownership rights. The threshold for management is for a position to exercise significant influence in the management of the associated enterprise. In calculating the influence or control of an individual, his spouse and his lineal ascendants or descendants are treated as a single person.

In indirect participations, the requirements relevant to capital and control will be fulfilled if the thresholds are reached by multiplying the rates of holding through successive tiers. A taxpayer holding more than 50% of the voting rights shall be deemed to hold 100%. Also see analysis in Part 6.3.

¹⁹⁵ This is because not all Member States participate in the OECD. Also, the CCCTB Directive is meant to go further than the OECD Model in that it gives more details on what ownership and control shall mean. CCCTB/RD\003, fn.9, paragraph 17.

2.5.5. Second, transfer pricing may still be relevant to non-CCCTB group companies, even if they are within the same Member State. Therefore, to an extent, the CCCTB will create a border within a Member State, for transfer pricing purposes.

2.5.6. Third, as there could never be consolidated group members in Member States that choose not to adopt the CCCTB – if Member States are allowed to do so – then, by analogy, absent of any unilateral measures by non-CCCTB Member States or third countries, there could never be consolidation and elimination of intra-group transactions between consolidated companies and companies in non-CCCTB Member States or third countries. Hence, separate accounting and the OECD Transfer Pricing Guidelines would still be applicable for dealings between such members.

2.5.7. This means that adjustments and corresponding adjustments may need to be made between associated enterprises. This could include CCCTB group companies and third country group companies as well as CCCTB companies and non-CCCTB EU group companies – as long as they fall within the definition of associated enterprises. Certainly vis-à-vis third countries, rights and obligations arising from tax agreements (e.g. transfer pricing provisions) would not be overridden by the CCCTB.¹⁹⁶ Therefore, there is nothing to stop a US affiliate suffering a large transfer pricing adjustment from seeking corresponding relief from the CCCTB group when the required associated relationship exists. Nor does it stop the US affiliate seeking corresponding relief from a non-CCCTB EU group company (e.g. a UK associated enterprise, if the UK opts out of the CCCTB). To the extent that CCCTB Member States have to respect their obligations under an agreement with a third country, so should non-CCCTB Member States.

2.5.8. However, the argument for overriding a transfer pricing arrangement between a CCCTB Member State and a non-CCCTB Member State becomes stronger considering that the draft CCCTB Directive takes precedence over any agreements between Member States.¹⁹⁷ Even though there is nothing to suggest that the draft CCCTB Directive would deviate from established transfer pricing practices and the existing OECD Guidelines when pricing adjustments are done pursuant to it,¹⁹⁸ there is always the risk that a different approach to transfer pricing might develop (i.e. a CCCTB approach or an EU approach).¹⁹⁹ Such a development would effectively place non-CCCTB Member States in an onerous situation, as they would be applying OECD principles vis-à-vis third country associated enterprises, and EU/CCCTB principles vis-à-vis CCCTB associated enterprises (as a result of their duties under enhanced co-operation). It is something that possible abstainers to the CCCTB project should take into account.

2.5.9. Again, it seems to be imperative for third countries, non-CCCTB Member States (if there are any) and even Member States that offer the CCCTB as an option to examine how to co-ordinate and combine formulary apportionment

¹⁹⁶ See analysis in 5.2.11 and 5.2.12.

¹⁹⁷ See Art 8 and, again, the analysis in 5.2.111 and 5.2.122.

¹⁹⁸ See Art 79, referred to in paragraph 2.5.4 above.

¹⁹⁹ For example, assume that the non-CCCTB country of the parent company makes an upwards adjustment in disagreement of the attribution of profits made by the CCCTB Member State of the consolidated subsidiary. This could be a breach of the relevant tax treaty between the non-CCCTB country and the Member State and/or discrimination contrary to the fundamental freedoms if the non-CCCTB country is also a Member State (again, assuming a Member State will be able to stay out of the CCCTB).

with separate accounting.²⁰⁰ The timing is arguably rather awkward now with the OECD's embrace of the 'functionally separate entity' approach in attributing profits to permanent establishment under Article 7 of the OECD Model, reflected in the revised model article of the 2010 version²⁰¹ and the recently approved Report on the Attribution of Profits to Permanent Establishments.²⁰²

2.5.10. In any case, Member States and third countries should ensure that the application of separate accounting for transactions between the CCCTB group and non-CCCTB affiliates does not lead to double taxation at the expense of the latter.

2.6 Formulary apportionment

2.6.1. The formula for apportioning the tax base will be comprised by a number of factors. In the last discussion document on the sharing mechanism, published in December 2007,²⁰³ the Commission appeared to be favouring a three-factor formula, based on company-specific data, with *labour* (consisting of equal weighted payroll and number of employees), *assets* (without intangibles and financial assets and inventory) and *sales* (measured at destination) as the relevant factors. Specific formulae were also suggested for certain sectors. The Commission suggested reviewing the formula after a period of five years.²⁰⁴

2.6.2. In this discussion document, the Commission stated that the sharing mechanism was aimed to 'be as simple as possible to apply for taxpayers and tax administrations and easy to audit for tax administrations; to be difficult to manipulate by taxpayers, i.e. the mechanism should not rely on factors the location of which are easy to move so as to artificially shift (part of) the consolidated taxable base to benefit from any differential in corporate income tax rates across the EU; and to distribute the tax base among the various entities concerned in a way that can be considered to be fair and equitable; and not to lead to undesirable effects in terms of tax competition'.²⁰⁵

2.6.3. Whilst the Commission stated that it was 'not the purpose of the sharing mechanism itself to replicate the current distribution of the national shares of multi-national groups' taxable profits', it acknowledged the political importance and sensitivity of potential budgetary implications for the Member States.²⁰⁶ The weighting of the factors was not a technical issue and any discussion on the weighting ought to be carried out at political level.²⁰⁷

²⁰⁰ For example, will there have to be more concentration on profit split methods of transfer pricing rather than traditional arm's length methods?

²⁰¹ The 2010 update to OECD Model was approved by the OECD on 22 July 2010.

²⁰² See OECD, 2010 Report on the Attribution of Profits to Permanent Establishments, approved on 22 July 2010. Available at <http://www.oecd.org/dataoecd/23/41/45689524.pdf> [Accessed 23 January 2011].

²⁰³ CCCTB/WP060\doc\en: 'CCCTB: Possible Elements of the Sharing Mechanism', fn.55. Also see Annex to CCCTB/WP/060: Synthesis of possible apportionment rules, published on the same date as the main discussion document. For general commentary, see, *inter alios*, Michael K Mahoney, 'Recommending an Apportionment Formula for the European Union's Common Consolidated Corporate Tax Base' 34 (2010) *Seton Hall Legislative Journal* 313; Jack Mintz & Joann M Weiner, 'Some Open Negotiation Issues involving a Common Consolidated Corporate Tax Base in the European Union' 62 (2008) *Tax Law Review* 81; Reuven Avi-Yonah & Kimberly Clausing, 'More Open Issues Regarding the Consolidated Corporate Tax Base in the European Union' 62 [2008] *Tax Law Review* 119; Joann M Weiner, 'Practical Aspects of Implementing Formulary Apportionment in the European Union' 8 (2007) *Florida Tax Review* 629.

²⁰⁴ *Ibid*, paragraph 68.

²⁰⁵ *Ibid*, paragraph 8.

²⁰⁶ *Ibid*.

²⁰⁷ *Ibid*, paragraph 13.

2.6.4. This formula was adopted in Art 86 of the draft CCCTB Directive, subject to a general safeguard clause if the formula were to lead to unfair results.²⁰⁸ For each factor, more detailed guidance was given in the discussion document on the sharing mechanism.²⁰⁹ Although the discussion document is not binding, the guidance therein may prove to be relevant as, under the draft Directive, the Commission has power to adopt acts laying down detailed rules on the calculation of the labour, asset and sales factors, the allocation of employees and payroll, assets and sales to the respective factor and the valuation of assets.²¹⁰

2.6.5. In so far as the labour factor was concerned, this would consist of two equal weighted elements: payroll of the workforce and number of employees.²¹¹ To calculate the share of the tax base for a given entity on the basis of the labour factor, pursuant to CCCTB/WP060 and Art 90 of the draft CCCTB Directive, it is necessary to compare the payroll and the number of the qualifying workforce attributable to that entity with the payroll and the number of the qualifying workforce attributable to the entire group. Where an individual employee is included in the labour factor of a group member, the amount of payroll relating to that employee will also be allocated to the labour factor of that group member.²¹² The definition of an employee is determined by the national law of the Member State where the employment is exercised.²¹³

2.6.6. Employees will be included in the labour factor of the group member from which they receive remuneration.²¹⁴ However, where employees physically exercise their employment under the control and responsibility of a group member other than that from which they receive remuneration, those employees and the amount of payroll relating to them shall be included in the labour factor of the former.²¹⁵ Persons who, though not employed directly by a group member, perform tasks similar to those performed by employees are also considered as employees.²¹⁶ Payroll includes the cost of salaries, wages, bonuses and all other employee compensation, including related pension and social security costs borne by the employer.²¹⁷ Payroll costs will be valued at the amount of such expenses, which are treated as deductible by the employer in a tax year.²¹⁸

2.6.7. As regards the scope of the workforce, all personnel employed²¹⁹ by a given entity would be covered. CCCTB/WP060 provided that the workforce would include managers and directors,²²⁰ personnel employed under interim/temporary contracts²²¹ but not outsourced services to third parties.²²² As regards the cost, under CCCTB/WP060 this would be the remuneration that was taken into account as a deductible expense for the purpose of calculating the tax

²⁰⁸ Art 87 of the draft CCCTB Directive. On request of the company and with authorisation from the tax administrations or on agreed request of all concerned tax administrations, an alternative method to share the tax base would be used.

²⁰⁹ CCCTB/WP060\doc\en: 'CCCTB: Possible Elements of the Sharing Mechanism', fn.55.

²¹⁰ Art 97. The implementing acts are to be adopted in accordance with the examination procedure referred to in Article 131(2) of the draft CCCTB Directive.

²¹¹ Arts 90–91 of the draft CCCTB Directive. Also see CCCTB/WP060, fn.55, paragraph 20.

²¹² Art 90(1).

²¹³ Art 90(3).

²¹⁴ Art 91(1).

²¹⁵ Art 91(2). This is subject to further conditions.

²¹⁶ Art 91(3).

²¹⁷ Art 91(4).

²¹⁸ Art 91(5).

²¹⁹ The definition of an employee would be based on the domestic legislation of the Member State where the employee worked and would be mutually recognised among Member States. CCCTB/WP060, fn.55, paragraph 22.

²²⁰ *Ibid.*

²²¹ *Ibid.*, paragraph 23.

²²² *Ibid.*, paragraph 24.

base, including fringe benefits, social contributions, stock options etc.²²³ As regards location, the focus would be the place where the employees provided their services.²²⁴ There were rules for seconded employees²²⁵ and for employees providing services to different entities in a tax year.²²⁶

2.6.8. In so far as the asset factor was concerned, again, under CCCTB/WP060, it was necessary to compare the value of the qualifying assets attributable to that entity with the value of the qualifying assets attributable to the entire group.²²⁷ Similarly, three elements needed to be known to define the factor: First, the scope of the assets; Second, the value; and Third, the location of the assets.²²⁸

2.6.9. As regards the scope of the qualifying assets, only fixed tangible assets owned, rented or leased are included.²²⁹ As clarified in CCCTB/WP060, intangibles, financial and current assets, including inventory, would be excluded. This was because inventory was mobile and as such prone to manipulation.²³⁰ As regards the valuation of the assets, what is taken into account for land and non-depreciable fixed tangible assets is the tax written down value of the assets,²³¹ or of the pool of assets in the case of non-individually depreciated assets.²³² As regards the location of assets, assets are attributed to the asset factor of its economic owner.²³³

2.6.10. In so far as the sales factor is concerned, this is going to be sales by destination.²³⁴ The sales factor is found by comparing the value of the total sales attributed to a given entity with the value of the total sales attributable to the entire group.²³⁵ This includes the proceeds of all sales of goods and supplies of services after discounts and returns, excluding value added tax, other taxes and duties. Exempt revenues, interest, dividends, royalties and proceeds from the disposal of fixed assets are not included in the sales factor, unless they are revenues earned in the ordinary course of trade or business. Intra-group sales of goods and supplies of services are not included.²³⁶

2.6.11. Sales of goods are to be included in the sales factor of the group member located in the Member State where dispatch or transport of the goods to the person acquiring them ends. If this place is not identifiable, the sales of goods are attributed to the group member located in the Member State of the last identifiable location of the goods.²³⁷ Supplies of services are included in the sales factor of the group member located in the Member State where the services are

²²³ *Ibid*, paragraph 25. The Commission rejected the proposal to have adjustments to correct differentials in wage levels across EU countries.

²²⁴ *Ibid*, paragraph 27.

²²⁵ Where a person was registered as an employee in one entity but effectively performed her/his activities for another entity, the seconded employee would be allocated in the payroll factors of the second entity. *Ibid*.

²²⁶ Their costs would be shared based on the number of months, subject to a *de minimis* rule. *Ibid*.

²²⁷ Arts 92–94 of the draft CCCTB Directive.

²²⁸ CCCTB/WP060, fn.55, paragraph 21, p.8.

²²⁹ Art 92(1). CCCTB/WP060, paragraph 30. This would include land and buildings, plant and machinery, other fixture and fittings, tools and equipment. Idle (i.e. not used) assets are also included.

²³⁰ *Ibid*, paragraph 31.

²³¹ Art 94(1) of the draft CCCTB Directive.

²³² Art 94(3). An individually depreciable fixed tangible asset shall be valued at the average of its value for tax purposes at the beginning and at the end of a tax year. Art 94(2).

²³³ Art 93. This article contains special rules for situations where the location of the assets does not coincide with the location of the economic owner of the assets – e.g. for rented/leased assets.

²³⁴ See Arts 95–96 of the draft CCCTB Directive. Also see CCCTB/WP060, paragraphs 33–36.

²³⁵ Art 95(1) of the draft CCCTB Directive. Also see CCCTB/WP060, paragraph 49.

²³⁶ Art 95(2) of the draft CCCTB Directive.

²³⁷ Art 96(1). Also see special rules in CCCTB/WP060, paragraph 55, for sales of immovable property. These could be located in the Member State where the immovable property is located, whereas sales of movable property could be located in the Member State where the goods are physically delivered, that is (if known) the place of ultimate destination.

physically carried out.²³⁸ Where exempt revenues, interest, dividends and royalties and the proceeds from the disposal of assets are included in the sales factor, they are attributed to the beneficiary.²³⁹

2.6.12. In CCCTB/WP060, the Commission emphasised that the formula would be applied uniformly across all Member States, though there could be sector specific formulae.²⁴⁰ It was recognised that there could be special formulae in areas such as financial services, transportation services and television and broadcasting services.²⁴¹ This would be by adapting as far as possible the factors in the general formula to the specificities of a particular sector rather than opting for a completely different formula. Such an approach would facilitate groups active in different economic sectors (conglomerates).²⁴² Indeed, the draft CCCTB Directive contains special provisions relating to financial institutions,²⁴³ insurance undertakings,²⁴⁴ oil and gas,²⁴⁵ and shipping, inland waterways, transport and air transport.²⁴⁶

2.6.13. Overall, the Commission has argued ever since the publication of CCCTB/WP060 that the suggested formula meets the objectives of simplicity and fairness, making it difficult to manipulate by the taxpayers as well as to lead to tax competition.²⁴⁷ However, the formula has been criticised on a number of grounds, as follows.

2.6.14. First, the exclusion of intangible property from the asset factor. The Commission had stated that the exclusion was not just to prevent abuse but for practical reasons, as it was sometimes very difficult to value intangible assets, especially self-generated intangible assets.²⁴⁸ Moreover, there were locational uncertainties when intangibles were created and/or used by the entire group and not by a single member of the group. As intangible assets were very mobile, they could be used to shift part of the factor from one tax jurisdiction to another.²⁴⁹

2.6.15. Whilst it is generally recognised that intangible assets are not easily valued or located, still this should not be exaggerated. As Business Europe Task Force had noted, given the high value of these assets and the high level of income they generate, 'any consideration of excluding them from the assets factor should be preceded by a thorough impact analysis'.²⁵⁰ This was very important because, as pointed out by the European Business Initiative on Tax (EBIT), by ignoring intangible assets and as a corollary intellectual property from the asset factor, an

²³⁸ Art 96(2).

²³⁹ Art 96(3). If there is no group member in the Member State where goods are delivered or services are carried out, or if goods are delivered or services are carried out in a third country, the sales are included in the sales factor of all group members in proportion to their labour and asset factors. See Art 96(4). This is the spread throw-back rule, which implicitly gives higher weighting to the labour and assets factors. (See CCCTB/WP060, paragraph 58.) If there is more than one group member in the Member State where goods are delivered or services are carried out, the sales shall be included in the sales factor of all group members located in that Member State in proportion to their labour and asset factors. See Art 96(5).

²⁴⁰ CCCTB/WP060, paragraph 14, page 6.

²⁴¹ *Ibid*, paragraph 69.

²⁴² *Ibid*, paragraph 70.

²⁴³ Art 98 of the draft CCCTB Directive.

²⁴⁴ Art 99.

²⁴⁵ Art 100.

²⁴⁶ Art 101.

²⁴⁷ CCCTB/WP060, paragraph 62. As the Commission noted further down, in paragraph 67, a mix of defined factors such as mobile assets as well as sales by destination provided a balanced outcome.

²⁴⁸ *Ibid*, paragraph 33.

²⁴⁹ *Ibid*.

²⁵⁰ Business Europe Task Force, Possible Elements of the Sharing Mechanism (2008), p.3. Available on http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/unicecomments_wp060.pdf [Accessed 29 January 2011]. Also see commentary by Mintz & Weiner (2008) fn.203, p.104.

'innovative' Member State would not be rewarded for being as such. No impact analysis has yet been published.²⁵¹

2.6.16. This choice of allocation keys would be advantageous, for example, to a group that is a publishing group with no material fixed assets in Europe, with a highly mobile employee base and with sales being made from one or two European and one or two US locations to its worldwide customer base. By contrast, it would not be advantageous to a manufacturing company with mainly local customers.

2.6.17. The Commission had also argued that intangible assets were in any case included in the apportionment formula via indirect means such as salaries of researchers and employees dealing with them, assets used for creating intangibles, proceeds in the sale of goods, which included in their value the value of intangibles.²⁵² However, in an impact assessment study on the CCCTB published by Ernst & Young,²⁵³ it was argued that this assumption did not apply in situations where a participating company has long held intellectual property from which it generated income. In such cases, 'there would be negligible contribution to the asset or payroll factor because of the limited additional personnel or assets required'.²⁵⁴ A similar point was made by EBIT in that even if intellectual property is included to some extent in the payroll and real estate based property factors, 'there is bound to be insufficient reward for innovation as the brand value uplift would be spread via the allocation formula and particularly the sales by destination element to all participating EU countries'.²⁵⁵

2.6.18. A second criticism was the use of the sales factor. The location of the sales may not be fixed and it can be manipulated for tax purposes. For example, if a sale was located according to where title passed, then a group could arrange to have title pass in a low-tax jurisdiction before it reached the customer.²⁵⁶ Furthermore, as the Business Europe Task Force commented, an independent sales agent located in a non-CCCTB country could be used to do the sale on behalf of the group in another market, thus moving the destination of the sales from one country to another.²⁵⁷ The Task Force also pointed out the inherent differences between sales by destination with the source principle, which 'has a strong conceptual position among Member States and has been the guiding principle in the OECD work on international taxation'.²⁵⁸ The shift to sales by destination may not be viewed fair and equitable to be accepted by Member States. The Task Force recommended that the formula exclude the sales factor.²⁵⁹ If not, then sales by origin would be preferable, though, again, this factor was easy to manipulate and would duplicate much of the assets and payroll factors.

2.6.19. A third criticism is the use of sector specific formulae. Whilst the need for such formula is obvious in the area of financial services, there is a risk of manipulation if too many formulae are introduced. The Ernst & Young study

²⁵¹ European Business Initiative on Tax (EBIT), Comments on CCCTB WP 57, 59, 60, 61 and 62, p.3. Available on http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/ebit_contrib_dec2007.pdf [Accessed 29 January 2011].

²⁵² The Commission expressed, however, their interest in contrary views. CCCTB/WP060, fn.55, paragraphs 33–35.

²⁵³ See Ernst & Young impact assessment study, fn.55, paragraph 5.4.1, p.53.

²⁵⁴ *Ibid.*

²⁵⁵ EBIT, fn.251, p.3.

²⁵⁶ Mintz & Weiner (2008), fn.203, pp.102–103.

²⁵⁷ Business Europe Task Force (2008), fn.250, p.1.

²⁵⁸ *Ibid.*, p.1.

²⁵⁹ *Ibid.*, p.3.

questioned whether sector specific rules were indeed necessary, as they might lead to companies falling within more than one sector. They might also lead to strong lobbying for more specific rules.²⁶⁰ The Business Europe Task Force had made similar comments to that effect, arguing that deviations from the standard formula should be kept to a minimum.²⁶¹ The Task Force also suggested incorporating a *de minimis* rule in that a sector-specific formula would only apply where the relevant activity accounted for a substantial part of the overall business activity, such as 25% or more.²⁶²

2.6.20. It should be acknowledged that no formula is perfect and any formula is likely to introduce opportunities for tax planning. For example, under the suggested formula, efforts will be made by groups to shift the labour and asset factors from EU countries with high corporate tax rates. Under another formula, there would be shifting of different factors. However, for a project as important as the CCCTB, one would have expected the Commission to devote further resources to this very part of any viable proposal. Unfortunately, this has not been the case.

2.6.21. With the benefit of this general discussion, the remainder of this report considers the effect of the CCCTB on the UK corporation tax system in specific areas and the implications of joining or abstaining from the CCCTB.

²⁶⁰ *Ibid*, see Summary Qualitative Considerations, xv–xvi.

²⁶¹ Business Europe Task Force (2008), fn.250, page 4.

²⁶² *Ibid*.

3. The UK tax system and the CCCTB

3.1 The UK tax base

3.1.2. In the UK, the rules for the calculation of the corporate tax base have recently been consolidated in three Acts: the Corporation Tax Act 2009 (henceforth, CTA 2009), the Corporation Tax Act 2010 (henceforth, CTA 2010) and the Taxation (International and Other Provisions) Act 2010. The Taxation of Chargeable Gains Act 1992 (henceforth, TCGA 1992) is also still relevant.

3.1.3. This part of the report looks at the UK rules very broadly, before focusing on the rules on group taxation. The aim of this exposition is to examine whether there are inherent differences with the proposed CCCTB. It also shows what the regime would be if the UK decided not to join the CCCTB zone or, even if it joined it, what the default rules would be if a UK group elected not to become a CCCTB group.

3.1.4. Under UK law, a company is within the charge to corporation tax if it is resident in the UK or, if not resident in the UK, it carries on a trade in the UK through a permanent establishment and only on the profits arising directly or indirectly through the permanent establishment.²⁶³ Corporation tax is charged on all the profits of a UK resident company in its accounting period.²⁶⁴ An accounting period begins when a company first comes within the charge to corporation tax – usually, when the company becomes resident in the UK, or acquires a source of income.²⁶⁵ After that, so long as the company remains within the charge to corporation tax, a new accounting period begins whenever an accounting period ends (being not more than 12 months from the start of the accounting period).

3.1.5. Broadly, the profits chargeable to corporation tax are the company's income²⁶⁶ and chargeable gains for that period.²⁶⁷ Income is computed in accordance with income tax law principles and chargeable gains are computed in accordance with capital gains tax principles. Capital allowances are deductible²⁶⁸ and balancing charges are considered as additions to profits.

3.1.6. The legislation prohibits certain deductions; namely, dividends or other distributions.²⁶⁹ Interest is deductible under the loan relationships legislation, which is now encapsulated in Part 5 of CTA 2009.²⁷⁰

3.1.7. Distributions received by a company from other companies are nominally taxable but usually exempt from corporation tax.²⁷¹ Annual interest, royalties and other annual payments form part of the total profits of the company chargeable to corporation tax. If income tax was levied on those payments, then the gross amount of the payments forms part of the company profits. The income tax levied

²⁶³ See section 5(2) CTA 2009.

²⁶⁴ Section 5 CTA 2009.

²⁶⁵ Section 9(1) CTA 2009.

²⁶⁶ Non-qualifying distributions and normally any dividends or other qualifying distributions received from UK resident companies are not income for corporation tax purposes.

²⁶⁷ Section 2 CTA 2009.

²⁶⁸ See Capital Allowances Act 2001.

²⁶⁹ Section 1305(1) and (2) CTA 2009.

²⁷⁰ See Part 5 of CTA 2009.

²⁷¹ Part 9A CTA 2009.

is set off against any tax assessable on the company. The company is entitled to repayment of any balance remaining.²⁷²

3.1.8. A company is entitled to relief for trading losses. Losses can only be relieved if they have been incurred while the company carrying on the trade is within the charge to corporation tax in respect of that trade.²⁷³ In the UK, there is no system of automatic consolidation of tax bases for group companies. Each company in a group computes its own profit and loss account. Tax liability is on a single entity basis. This means that if a group company has profits, its starting point is that it has to pay taxes on these, without regard to any losses suffered by other group companies.

3.1.9. This approach, however, does not reflect economic reality because a group of companies tends to function as a single economic unit, one enterprise. Therefore, recognising and taxing profits made by some members of the group but ignoring or not absorbing losses incurred by other members is thought to be distortive of economic reality and does not reflect the financial wellbeing of the group. In the UK recognition is given to the fact that a group of companies is a single economic unit. This takes the form of various reliefs for group of companies; namely, group relief for losses and relief for intra-group transactions. There are also rules that enable group entities to file their tax returns together. These rules are considered next.

3.2 Cross-border relief for losses

3.2.1 Group relief rules

3.2.1.1. The UK group relief rules are designed to enable certain group companies (surrendering companies) to surrender specific types of losses to other group companies (claimant companies). As a result, the losses of the surrendering company can be set off against the profits of the claimant company, thus reducing the overall tax liability of the latter company. The kind of losses that can be surrendered are the following: current trading losses, excess capital allowances, a non-trading deficit on loan relationships, excess management expenses, excess non-trading losses on intangible fixed assets and excess charges. Group relief can only be surrendered on a current year basis against the current year total²⁷⁴ profits of the claimant company.

3.2.1.2. Only companies can be members of a group for group relief purposes. Although non-UK resident companies can be members of a group, both the surrendering company and the claimant company must either be UK tax resident or be carrying on a trade in the UK through a permanent establishment. As shown below, group relief for EU/EEA losses may also be granted under specific circumstances.

3.2.1.3. The UK group relief regime is an elective regime. In other words, it is not automatic. It is up to the surrendering company to decide whether to surrender its losses,²⁷⁵ the amount of those losses and to which group company or companies²⁷⁶ (assuming they satisfy the criteria for group relief). The

²⁷² Section 967 CTA 2010.

²⁷³ See sections 36–44 CTA 2010.

²⁷⁴ This includes chargeable gains.

²⁷⁵ Only current year losses can be surrendered. Sections 99–100 CTA 2010.

²⁷⁶ Relief may be claimed by more than one company in the group or member of the consortium.

surrendering company is free to choose to carry losses forward to reduce its tax liability on future profits or, in the case of certain losses, carry them back against the profits of previous periods.

3.2.1.4. Why would a group company decide to surrender losses to another group company? Generally, it is thought to be beneficial to surrender losses by way of group relief rather than carry them forward, as the group will be able to defer the timing of its tax payments. However, once a company surrenders its losses by way of group relief, these losses cease to be available for set-off against future profits of the surrendering company.

3.2.1.5. Group relief is only available to 75% groups.²⁷⁷ This means that one company must be a 75% subsidiary²⁷⁸ of another or both are 75% subsidiaries of a third company.²⁷⁹ Also, the parent company must be entitled to not less than 75% of any profits and on a winding up to not less than 75% of any of its assets available for distribution to the equity holders of the subsidiary company.²⁸⁰

3.2.1.6. There are a number of anti-abuse rules to prevent loss-making companies being brought into the group just so as to use their losses. These rules seek to ensure that only those losses that are incurred whilst the surrendering company is in the group can be surrendered and they can only be set off against those profits of the claimant company that are earned whilst it is in the group.

3.2.1.7. There is also a provision that prevents a company from being considered as a member of a group if 'arrangements'²⁸¹ are in existence for the transfer of that company to another group or for any person to take control of the company but not the other companies within the group.²⁸² Relief is not available during the period in which such arrangements are in force.

3.2.1.8. Group relief is only available for the overlapping accounting periods of the surrendering and the claimant companies. Where the surrendering and the claimant companies' accounting periods do not coincide, the amount of group relief is apportioned according to the overlapping losses and profits. Also, when a company joins or leaves the group, the losses of the relevant accounting periods are apportioned to ensure that only losses of post-entry or pre-departure periods are used.

3.2.1.9. A claim for group relief must be made by the claimant company in its tax return for the accounting period for which the claim is made. The claimant company has to specify the amount of relief claimed and the name of the surrendering company. The tax return also has to contain the written consent of the surrendering company. It is possible for a group to enter into arrangements with HMRC, under which claims and consents can be made in a single document (often referred to as a joint amended return).²⁸³ Claims for relief must be made

²⁷⁷ Sections 131, 150–152 CTA 2010. There are also provisions for consortia but these are not examined in the report.

²⁷⁸ The ownership percentage refers to ordinary (issued) share capital.

²⁷⁹ Section 152 CTA 2010.

²⁸⁰ Section 151(4) CTA 2010.

²⁸¹ The term 'arrangements' is broadly construed. When an option is granted, in order to calculate the extent of the equity holder's entitlement to profits or assets one must calculate the entitlements on the assumption that the option has been exercised. The equity holder is then treated as being entitled only to the lower of the percentage entitlement before the option is exercised and the percentage entitlement after the option is exercised. See section 174(1) CTA 2010.

²⁸² Sections 154–156 CTA 2010.

²⁸³ Simplified arrangements under Corporation Tax (Simplified Arrangements for Group Relief) Regulations 1999 (SI1999/2975).

by the first anniversary of the filing date, which normally means within a two-year period from the end of the accounting period. If there is an enquiry into the tax return, the time limit is extended to 30 days after the enquiry is concluded.

3.2.1.10. Following the decision in *Marks & Spencer*, entitlement to claim group relief for EU/EEA losses was granted under the Finance Act 2006,²⁸⁴ but subject to strict conditions. Under the new rules, the surrendering company must be a subsidiary of a claimant company, which is resident in the UK or the surrendering company and the claimant company must be 75% subsidiaries of a third party, which is resident in the UK. Also, the surrendering company must be within the charge to tax under the law of any EEA territory either because it is resident there or because it trades through a branch there.

3.2.1.11. Four conditions have to be satisfied for group relief to be available in such circumstances, as follows.

3.2.1.12. First, the overseas loss has to be of a kind relievable in the UK (e.g. not a capital loss).²⁸⁵ In other words, the loss must be such that had it been incurred in the UK, it would have attracted group relief. This is the equivalence condition.

3.2.1.13. Second, the amount of loss has to give rise to a tax loss under the rules of the relevant EEA territory.²⁸⁶ If the loss is incurred by an EEA branch of a non-EEA company, then the loss must not be attributable to activities, which would be exempt from tax in the EEA territory as a result of a double taxation convention. This is the EEA tax loss condition.

3.2.1.14. Third, no relief is possible in any other period (current, previous or future period) for the loss in the EEA territory in which the subsidiary is resident or any territory outside that of the EEA territory and the UK.²⁸⁷ This is the qualifying loss condition.

3.2.1.15. Fourth, no relief is possible in the territory of residence of any intermediate company between the surrendering company and the UK resident company.²⁸⁸ The intermediary company must be at least a 75% subsidiary of the UK resident company. This is the precedence condition.

3.2.1.16. These conditions are underpinned by a general anti-abuse provision. No relief is available if arrangements are in place either to turn an existing loss into a loss that qualifies for relief or to give rise to a new loss that qualifies for relief, and the main purpose or one of the main purposes of these arrangements is to secure such group relief.²⁸⁹

3.2.1.17. Arguably, the four conditions that need to be satisfied under the amended rules seem much stricter than the *Marks & Spencer* test. For example, in *Marks & Spencer*, the proportionality test was phrased in terms of the non-resident subsidiary having exhausted the possibilities of having the losses taken

²⁸⁴ Sections 402, 403A, 403D Income and Corporation Taxes Act 1988 were amended and new provisions inserted (sections 403F, 403G, Schedule 18A). The provisions are now to be found in sections 111–128 CTA 2010.

²⁸⁵ Sections 113(2) and 114 in CTA 2010.

²⁸⁶ Sections 113(2) and 115–116 in CTA 2010.

²⁸⁷ Sections 113(2) and 117–120 in CTA 2010.

²⁸⁸ Section 113(2) and 121 CTA 2010.

²⁸⁹ Section 127 and Schedule 2 paragraph 52 in CTA 2010. 'Arrangements' includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable). See HMRC Manual on Company Taxation, CTM81555.

into account *in its State of residence*.²⁹⁰ In other words, the spectrum for determining the proportionality of the group relief rules was more limited; one only looked at the tax treatment in the State of residence of the loss-making subsidiary. By contrast, it is obvious from the qualifying loss condition and the precedence condition of the amended UK rules that the spectrum is much broader. In examining whether the non-resident subsidiary had exhausted the possibilities of having its losses absorbed, one is forced to look at the tax treatment at the State of residence of the subsidiary and in *any other EU/EEA state*, as well as the State of residence of any *intermediary* companies.

3.2.1.18. The restrictive ambit of the UK rules can be further illustrated, if one considers the timing issue. The time for testing the availability of other relief was considered by HMRC in *Marks & Spencer* to be the end of the accounting period in respect of which the UK resident company was claiming group relief. It is also stated as such in HMRC's Company Taxation Manual, where the new legislation is analysed.²⁹¹ Pursuant to this interpretation, it is very difficult to satisfy the test unless the overseas company ceased trading at the end of the period in which the loss arose. Therefore, in practice, it could be argued that it makes the claiming of relief very onerous.

3.2.1.19. Arguably, this position may not be tenable now following the judgments of the English courts in *Marks & Spencer*. When the case went back, the courts had to decide how the exhaustion of possibilities test²⁹² was to be applied. In the High Court,²⁹³ Park J found that 'possibilities available' meant 'recognised possibilities legally available given the objective facts of the company's situation at the relevant time'.²⁹⁴ A possibility could exist, even if it was unlikely that it would ever happen.²⁹⁵ However, it was unnecessary to show that there was not 'some other possible way of getting relief for the losses'.²⁹⁶ The relevant time for the application of the exhaustion of possibilities test was when the UK parent company made the claim for group relief and not when the loss was incurred.²⁹⁷ The Court of Appeal²⁹⁸ approved the High Court's interpretation of the exhaustion of possibilities test.²⁹⁹

3.2.1.20. The guidance given by the High Court and the Court of Appeal on the interpretation of the exhaustion of possibilities test was followed when the case was remitted to the Tax Chamber of the First-Tier Tribunal.³⁰⁰ It was also

²⁹⁰ See paragraph 55 of the *Marks & Spencer* judgment, fn.144.

²⁹¹ CTM81570.

²⁹² The English courts tended to describe this test as the 'no-possibilities' test. In this report the phrases 'exhaustion of possibilities' and 'no-possibilities' test are used interchangeably.

²⁹³ *Marks & Spencer plc v. Halsey* [2006] EWHC 811 (Ch), [2006] STC 1235.

²⁹⁴ *Ibid*, paragraph 33.

²⁹⁵ *Ibid*, paragraph 37.

²⁹⁶ *Ibid*.

²⁹⁷ HMRC had argued that the possibility of other relief had to be considered at the end of the accounting period of the loss. Park J thought that this was too soon and would likely rule out virtually every case. He felt that there was no need to refer the case back to the Court of Justice to answer this question. *Ibid*, paragraphs 44–46. Ironically, this is one of the 'flaws' that the Commission has identified in the amended UK legislation.

²⁹⁸ *Marks & Spencer plc v. Halsey* [2007] EWCA Civ 117, [2008] STC 526.

²⁹⁹ Lord Justice Chadwick, who in the Court of Appeal delivered the main judgment with which Tuckey LJ and Jacob LJ concurred, interpreted the test in a similar way. He thought that the exhaustion of possibilities test would not 'be satisfied if the claimant did no more than demonstrate that it was improbable or unlikely, or that there was little or no real likelihood, or that the claimant (or the surrendering company) had no intention, that losses could or would be set against future profits. [...] Given the context, the phrase "no possibility" in the second condition is to be read as "no real possibility"; in the sense that a real possibility is one which cannot be dismissed as fanciful.' Lord Justice Chadwick also agreed with Park J on the timing issue. *Ibid*, paragraphs 48–49, 58. HMRC was not given permission by the House of Lords to appeal this point.

³⁰⁰ *Marks & Spencer plc v. Halsey (Inspector of Taxes), First-Tier Tribunal (Tax Chamber)* [2009] UKFTT 64 (TC), [2009] SFTD 1. The Tribunal Judges examined in greater detail the four group claims made concerning the losses of German and Belgian subsidiaries of the UK parent company. This decision was delivered on 2 April

followed by the Upper-Tribunal,³⁰¹ which clarified that the test should be applied to each euro of losses rather than to the amount of loss as a whole.³⁰²

3.2.1.21. Technically, in these cases, the timing issue was raised in the context of the *previous* group relief legislation. However, there is no reason why the same approach cannot be followed vis-à-vis the new legislation – although this cannot be an automatic assumption. In any case, whether this new legislation can in fact be ‘rescued’ by an EU-friendly interpretation of analogous or previous legislation by national courts may, now, have become a moot point. This is because the new UK group relief regime has again been targeted by the Commission.

3.2.1.22. In a reasoned opinion in 2008, the Commission expressed the view that the amended legislation was still restrictive and not aligned with the spirit of the Court’s decision in *Marks & Spencer*.³⁰³ The Commission demanded the proper implementation of this decision otherwise it would refer the matter to the Court of Justice. In October 2009, the Commission announced that it had initiated infringement proceedings against the UK.³⁰⁴ The Commission repeated the point that although the legislation had been amended, the UK continued to impose conditions on cross-border group relief ‘which in practice [made] it impossible or virtually impossible for the taxpayer to benefit from such relief in accordance with the judgment in *Marks & Spencer*’. In fact, the Commission has based its challenge on some of the restrictive elements of the new legislation identified above.

3.2.1.23. First, the Commission believed that there was an unnecessarily restrictive interpretation of the condition that there should be no possibility of use of the loss in the State of the subsidiary.³⁰⁵ Second, the time period allowed for proving the exhaustion of possibilities test was thought to be very limited.³⁰⁶ Third, the legislation only applied to losses incurred after 1 April 2006.³⁰⁷ As a result, no protection was offered for losses incurred prior to that date. According to the Commission, these conditions rendered the UK legislation incompatible with the freedom of establishment.

3.2.1.24. Therefore, the UK seems to be getting embroiled in another legal battle over group relief rules. This time, the target is the new regime that was actually put in place to ensure compliance with the *Marks & Spencer* judgment.

3.2.1.25. Pending the result of this latest infringement proceeding, it appears that in strictly confined situations – perhaps even stricter than what the Court of Justice stipulated in *Marks & Spencer* – the UK rules have become less territorial.

2009. On 24 August 2009, the Tribunal Judges delivered a second decision on the quantum of losses: *Marks & Spencer Plc v. HMRC* [2009] UKFTT 231 (TC). For case analysis, see Simon Whitehead, ‘Cross-Border Group Relief: The Latest Instalment in Marks & Spencer’ [2009] *Tax Analysts* (4 May 2009 WTD 83-3); Roopa Aitken & Natalie Carroll, ‘Relief for M&S’ (2009) *Tax Journal*, issue 981, 4, 18 May 2009; case comment, ‘*Marks and Spencer Plc (Appellants) v. Her Majesty’s Commissioners of Customs and Excise (Respondents)*’ [2009] UKHL 8’ 18 [2009] *EC Tax Review* 139–140.

³⁰¹ *The Commissioners for Her Majesty’s Revenue and Customs v. Marks & Spencer* [2010] UKUT 213 (TCC).

³⁰² *Ibid*, paragraphs 48–57.

³⁰³ As the Commission stated: ‘... although the legislation has been amended, the UK still imposes conditions on cross border group relief which in practice make it impossible or virtually impossible for the tax payer to benefit from tax relief pursuant to the judgment in Marks & Spencer’: IP/08/1365, 18 September 2008.

³⁰⁴ IP/09/1461, 8 October 2009. The Commission’s case reference number is 2007/4026.

³⁰⁵ Paragraph 7 of Schedule 18A of the Income and Corporation Taxes Act 1988, repealed and replaced by sections 117–119 CTA 2010. This author also argues that the precedence condition is equally restrictive.

³⁰⁶ The parent company had to demonstrate that the condition that there should be no possibility of use of the loss in the State of the subsidiary was met as from immediately after the end of the accounting period in which the loss arises. Paragraph 7(4) of Schedule 18A, repealed and replaced by section 119(4) CTA 2010.

³⁰⁷ Part 3 of Schedule 1, Finance Act 2006.

In other words, in such situations, there is no need for the locus of the loss to be in the UK. Is the effect, however, similar to the consolidation mechanism of the CCCTB? In order to make an accurate comparison, it is necessary to consider the availability of relief for losses of overseas permanent establishments of UK companies to other group companies and not just losses of non-resident group companies. This is because, as seen above, under the CCCTB proposal the profits of an EU (CCCTB)³⁰⁸ permanent establishment are included in the consolidated base. This means that losses of such a permanent establishment would be automatically absorbed within the consolidated base.

3.2.1.26. Is this the case also in the UK? This is examined next.

3.2.2 Group relief for overseas permanent establishment losses

3.2.2.1. Under the UK rules, there is unlimited cross-border loss relief within the same company (i.e. as between the head office and the permanent establishment). This is because a UK company is taxed on its worldwide profits, including profits of its overseas permanent establishments (although following the Finance Act 2011 this is now subject to an election to exempt foreign branch profits). As a corollary, losses of an overseas permanent establishment are automatically consolidated and set-off against profits of the head office as these are losses *of the same company*. What about profits of other UK group companies? Can the permanent establishment offset its losses against their profits? Can those losses be surrendered as group relief?

3.2.2.2. Under section 403E Income and Corporation Taxes Act 1988, now repealed and replaced by sections 106 and 108 CTA 2010, group relief may be available for loss incurred by an overseas permanent establishment of a UK company but, again, subject to strict conditions. The loss cannot be surrendered as group relief if it is attributable to the overseas permanent establishment and tax relief could be given in *any* foreign jurisdiction on *any* part of that loss to someone other than the UK company.³⁰⁹

3.2.2.3. According to HMRC's Manual on Company Taxation,³¹⁰ the restriction applies where any person, other than the UK resident company, can deduct from non-UK profits any part of the loss, or an amount representing any part of the loss, for the purposes of foreign tax in the jurisdiction where the permanent establishment is situated. The restriction also applies where any person, other than the UK company, can *otherwise* get relief in respect of the loss (by allowance against non-UK profits) from a foreign tax in that jurisdiction. In other words, if *any* sort of loss relief is available to *any* person, other than the UK head office, in *any* foreign jurisdiction, then the UK will not allow the losses of the overseas permanent establishment to be surrendered as group relief to other UK group companies.

3.2.2.4. Again, this seems to be a very strict test. First, it looks at whether relief *can* be obtained elsewhere – not whether *it has been* obtained elsewhere. Second, the mere availability of relief to *any* person other than the UK head office prevents the permanent establishment from surrendering its losses. Therefore,

³⁰⁸ This is because if, as predicted, some Member States stay out of the CCCTB, then obviously permanent establishments established in those Member States would not be consolidated with their CCCTB head office.

³⁰⁹ See sections 106(2), (7), 108(1)–(2) and 187, CTA 2010.

³¹⁰ CTM80360.

the mere availability of relief (arguably, even in the future) to any person anywhere would suffice to bring the situation outside the ambit of the UK rules. Technically, the permanent establishment would have to show that no relief (full or partial) is available to anyone, anywhere, at any time!

3.2.2.5. Is this test compatible with EU law? Again, it could be argued that these conditions are so strict that they go beyond the stipulations of the *Marks & Spencer* 'exhaustion of possibilities' test. The same argument was made above when the conditions for group relief between companies were concerned.

3.2.2.6. Therefore, notwithstanding the amendments to the UK rules due to recent case law of the Court of Justice, it still remains speculative whether the UK rules indeed comply with EU law. In fact, there is now a reference to the Court of Justice from a UK court questioning whether the UK group relief rules relating to permanent establishments violate freedom of establishment.³¹¹ In any case, it is obvious that in so far as overseas losses of a permanent establishment are concerned, the current UK rules are more restrictive than what is envisaged under the CCCTB proposal.

3.2.2.7. However, in the June Budget 2010, the Government announced its plans to move to a more territorial basis for taxing the profits of foreign branches of UK companies.³¹² This is part of the Roadmap for corporate tax reform. A discussion document was published on 27 July 2010,³¹³ with a consultation period running until 15 October 2010. The proposals were enacted in the Finance Act 2011, allowing companies to elect to exempt foreign branch profits.

3.2.3 'Group relief' within the CCCTB

3.2.3.1. Under the CCCTB, group relief is automatically available for consolidated entities. As mentioned previously, the tax bases of qualifying subsidiaries³¹⁴ of the CCCTB group (and their PEs) are consolidated.³¹⁵ Therefore, losses incurred by one consolidated member company are automatically offset against profits of another consolidated member company, regardless of their Member State of residence or establishment.

3.2.3.2. Losses incurred by a company prior to joining a CCCTB group are not to be taken into account for consolidation. Such losses will be offset against the share of the future consolidated profits attributed to that company in accordance with national rules on loss carry forward.³¹⁶ This had been reiterated in the latest Commission discussion document on reorganisations (CCCTB/RD\002).³¹⁷

³¹¹ Case C-18/11 Reference for a preliminary ruling from Upper Tribunal (Tax and Chancery Chamber) (United Kingdom) made on 12 January 2011 – *HMRC v. Philips Electronics UK Ltd.*

³¹² See http://www.hm-treasury.gov.uk/consult_taxation_of_foreign_branches.htm [Accessed 1 August 2010].

³¹³ See HM Treasury, Foreign Branch Taxation: A discussion document. See http://www.hm-treasury.gov.uk/d/consult_taxation_of_foreign_branches_discussion.pdf [Accessed 23 January 2011].

³¹⁴ See Art 54.

³¹⁵ Art 57.

³¹⁶ See Art 48 (Pre-entry losses) and Art 64 (Losses on entering the group), where there appears to be some overlap. It would seem that the former provision relates to pre-entry losses incurred by a taxpayer before opting into the *system* (i.e. applying the new tax base without necessarily consolidation) and the latter provision relates to pre-entry losses incurred by a taxpayer or PE before entering a *group* (i.e. applying the new tax base and consolidation). Also see the precursor to this provision in paragraph 100, CCCTB57, fn.20.

³¹⁷ See CCCTB/RD\002, paragraphs 4–5, fn.9. It had also been suggested by commentators that the ring-fencing of pre-consolidation losses ought to be subject to a flow back clause in that if losses cannot be used domestically, they should be offset against the consolidated tax base. See comments by Business Europe Task Force, on paragraphs 4–5.

However, CCCTB/RD\002 also contained specific provisions on pre-consolidation losses within reorganisations. If as a result of a reorganisation the group member ceased to exist, leaving behind a PE, then the pre-consolidation losses would be deductible against the share apportioned to the PE.³¹⁸ If there was no taxable presence in the departing Member State, then a permanent establishment would be deemed to exist.³¹⁹ In cases of reorganisations between two or more CCCTB groups, pre-consolidation losses were ring-fenced.³²⁰

3.2.3.3. These latter provisions do not, however, appear to feature explicitly in the main body of the draft CCCTB Directive, which only contains a provision on the treatment of losses of a previously existing group following a business reorganisation or a merger.³²¹ Here, it is stated that where, as a result of a business reorganisation, one or more groups, or two or more members of a group, become part of another group, any unrelieved losses of the previously existing group or groups shall be allocated to each of the members of the latter (i.e. the existing group) according to the formula and carried forward.³²² To an extent, the deemed PE provision is implied, as the merger has to be a merger in accordance with the criteria of Merger Directive 2009/133/EC.³²³

3.2.3.4. Once a company is part of the consolidated group, then any future losses it makes are effectively locked in. The CCCTB loss rules operate, henceforth, for the net losses of the entire CCCTB group. This means that when consolidation results in an overall loss for the CCCTB group, then this loss is carried forward at group level and set off against future consolidated profits, before the net profits are shared out.³²⁴ CCCTB losses are eligible for carry forward indefinitely – there can never be any carry back whether the company is a consolidated one³²⁵ or simply a company of a group voluntarily adopting the CCCTB.³²⁶

3.2.3.5. It also means that no losses are attributed to a company leaving the group. Therefore, when a CCCTB group company is sold, any unrelieved losses carried forward at group level remain in the group,³²⁷ however small that group becomes as a result of exiting members. It is only when the group terminates that unrelieved losses are attributed to companies belonging to the consolidated group at the moment of termination.³²⁸

³¹⁸ *Ibid*, paragraph 17.

³¹⁹ *Ibid*.

³²⁰ *Ibid*, paragraph 24. When a group (or part of a group) becomes part of another group by way of an acquisition of shares allocated to each group member using the formula as it stands at the time of the reorganisation (*ibid*, paragraph 26). In case of a merger, pre-reorganisation group losses are allocated to each group member of the absorbed group or both groups (*ibid*, paragraph 28).

³²¹ See Art 71 (Treatment of losses where a business reorganisation takes place between two or more groups).

³²² Also see paragraph 17 of the preamble, which refers to rules on reorganisations stating that ‘where a company enters the group, pre-consolidation trading losses should be carried forward to be set off against the taxpayer’s apportioned share’.

³²³ See Art 71(2). Art 5 of the Merger Directive provides for deferral of taxes in the Member State of the dissolving company for qualifying transfers of assets and stock that are taken over by a permanent establishment of the receiving company in the Member State of the transferring/acquired company.

³²⁴ See Art 43 of the draft CCCTB Directive.

³²⁵ CCCTB57, fn.20, paragraph 84.

³²⁶ See CCCTB/RD\001, fn.9, paragraph 2.

³²⁷ Art 69 of the draft CCCTB Directive. This should be read in light of Art 53 (Losses on leaving the system), which stipulates that ‘losses incurred by the taxpayer which have not yet been set off against taxable profits under the rules of the system provided for by this Directive shall be carried forward in accordance with national corporate tax law’.

³²⁸ See Art 65. Art 66 sets out how losses shall be treated following the termination of the group. It is only if the taxpayer leaves the system that losses are to be carried forward and set off according to the national corporate tax law (Art 66(c)). By contrast, if the taxpayer remains in the system but outside the group, the losses shall be carried forward under Art 43 (Art 66(a)). If the taxpayer joins another group, the losses shall be carried forward and set off against its apportioned share (Art 66(b)). Also see CCCTB/RD\001, paragraph 104.

3.2.3.6. Overall, even though the loss relief rules are scattered in the draft CCCTB Directive³²⁹ and their scope is at times difficult to delineate, they broadly follow the suggestions of previous discussion documents. In essence, once a company becomes a member of a consolidated group, the power to deal with its losses is lost, at least until the CCCTB group dissolves. Whilst this may be unproblematic when the whole group is a CCCTB consolidated group, it may be an issue if there are profitable group companies that are not consolidated or not CCCTB companies at all. Unrelieved losses of the consolidated group companies would be carried forward – they could not be set off against current profits of non-consolidated group companies. Therefore, opting to become a CCCTB group is an important long-term policy decision.

3.2.4 Group relief versus consolidation

3.2.4.1. In light of the current state of the UK group relief rules, taking into account the latest changes, can it be argued that the divergence between the UK rules and the consolidation mechanism of the CCCTB has, to a large extent, been bridged, removing the urgency to adopt the latter? Or, if the latter is adopted, then would the impact be minimal?

3.2.4.2. Obviously, the analysis above suggests that there are still inherent differences between the UK group relief system and the consolidation mechanism of the CCCTB.

3.2.4.3. First, there is no single tax base for the members of the group or at least those members that will surrender losses between themselves. Group entities retain their fiscal autonomy and integration is limited between the surrendering and claimant companies. By contrast, with consolidation, a single tax base is created. This allows profits and losses of individual group members to be set off against one another and intra-group asset transfers to be tax neutral.

3.2.4.4. Second, under a group relief system, the relief of losses is on an entity-by-entity basis: losses are surrendered from certain loss-incurring group members to certain profit-making ones and only for overlapping accounting periods. Group relief is on a current year basis – no losses are ‘locked-in’ for future use by the claimant company. Also, the claimant company has to make a claim for this in the relevant accounting period, enclosing the written consent of the surrendering company.³³⁰ So, there is limited transfer of group company tax bases and in a highly prescribed manner. By contrast, under the CCCTB, there is no need for group companies to make bilateral arrangements between themselves, at least not those companies that are subject to the consolidation mechanism.³³¹ Also, the head entity of the group (the principal taxpayer) is responsible for all or most of group’s tax obligations.³³²

3.2.4.5. Third, group relief is voluntary. It is up to the surrendering company to decide whether, if at all, it wants to surrender its losses. Of course, some

³²⁹ Loss relief rules are found in Chapter VII ‘Losses’, Chapter VIII ‘Provisions on entry to and exit from the system provided for by this directive’, Chapter X ‘Entering and leaving the group’, Chapter XI ‘Reorganisations’.

³³⁰ As mentioned above, there is scope for the group to enter into arrangements with HMRC under which claims and consents can be made in a single document.

³³¹ Companies that are not CCCTB group members would be subject to domestic rules on group relief. See Part 4 below.

³³² See Part 3.5 below on the administrative aspects.

recognition ought to be given to the fact that an eligible surrendering company is controlled by the parent company that can influence its actions. However, the starting point is that the decision to surrender losses is, technically, taken on an *ad hoc* basis, depending on the current financial situation of group members. By contrast, under the CCCTB, consolidation is automatic. Once the group (again, technically, the head company or, in CCCTB parlance, the principal taxpayer) elects to become a CCCTB group, then consolidation is automatic for group companies that satisfy the threshold criteria.³³³ Furthermore, this is a decision that binds the group for five years.

3.2.4.6. Fourth, although the UK rules *prima facie* allow relief for overseas losses, the legislation restricts the availability of this relief to very limited circumstances. As mentioned, the four conditions that need to be satisfied under the amended rules for UK group companies to use the losses of non-resident group companies seem much more onerous than the *Marks & Spencer* test. In examining whether the non-resident subsidiary had exhausted the possibilities of having its losses absorbed, one has to look at the tax treatment at the State of residence of the subsidiary and any other EEA state, as well as the State of residence of any intermediary companies.

3.2.4.7. Regardless of whether one considers these conditions to be an accurate reflection of the *Marks & Spencer* test – the Commission certainly does not think so – the conditions imposed show that cross-border group relief in the UK is anything but automatic or easily available. By contrast, the consolidation mechanism under the CCCTB is premised on the assumption that it is going to be automatic, expedient and that it would do away with the territoriality restrictions of national group relief systems.

3.2.4.8. Similar restrictions seem to apply vis-à-vis the losses of an overseas permanent establishment. Under the current rules, if *any part* of the loss is relieved elsewhere, then *none* of the losses of the permanent establishment can be used by other group companies for group relief purposes. It was argued above³³⁴ that this may not be in line with the *Marks & Spencer* test.

3.2.4.9. On the basis of the above discussion, it seems that notwithstanding the amendments to the UK group relief rules, the divergence between these rules and the consolidation mechanism of the CCCTB has not at all been bridged. Therefore, if the UK decides *not* to adopt the CCCTB, then it would have to take into consideration the fact that some other Member States would be offering the option of a consolidation regime (and further arbitrage possibilities) to multinationals and holding companies established therein.

3.2.4.10. The UK would also have to take into consideration the recent cases of the Court of Justice, which may bring about further inroads to its domestic system. *Philips Electronics*³³⁵ is a good example of a case in which an English court followed a judgment of the Court of Justice and found domestic legislation incompatible with EU law, without needing to make a reference to the Court. Here, the Judges of the First-Tier Tribunal examined the UK consortium relief rules and, more specifically, the requirement that for consortium relief to be

³³³ See discussion in Part 2.1 above.

³³⁴ See Part 3.2.2.

³³⁵ *Philips Electronics UK Ltd v. HMRC* [2009] UKFTT 226 (TC), [2009] SFTD 629.

available, the 'link' company had to be UK resident.³³⁶ They found this to be a clear restriction.

3.2.4.11. The Tribunal Judges thought that *Société Papillon*³³⁷ provided a clear precedent and was identical in all material respects to the situation of the link companies. In *Société Papillon*, relief for losses between two French companies was restricted by the existence of the Dutch intermediate company. Here, group relief between the UK branch and the UK company was restricted by the existence of non-UK link companies.³³⁸ The Tribunal Judges concluded that the restriction³³⁹ was not justified³⁴⁰ on the basis of fiscal coherence and the balanced allocation of taxing rights. Therefore, freedom of establishment was infringed. The Tribunal Judges were confident in their analysis and saw no need to refer this case to the Court of Justice.

3.2.4.12. Whatever the state of the case law at the Court of Justice and its level of incorporation in the UK, the availability of relief for losses of non-resident group companies or overseas permanent establishments is only one of the factors to take into account in making the comparison between the UK regime and the CCCTB. Consolidation under the CCCTB is not just about loss relief. It also encompasses tax-free intra-group asset transfers and disposals of major shareholdings. A comparison between the CCCTB provisions and the UK rules in these areas needs, therefore, also to be made.

³³⁶ Under section 406(2) of the Income and Corporation Taxes Act 1988, now repealed and replaced by sections 133(1), (3), (4), 145(2), 147(2), 148(2), 149(2) CTA 2010, a group member could make a consortium claim but only if the link companies themselves could have made consortium claims. However, as none of the link companies were UK resident and carried on no business in the UK, no consortium claim could be made.

³³⁷ Case C-418/07 *Société Papillon*, fn.161.

³³⁸ *Philips Electronics*, fn.335, p.5, paragraphs 40–43.

³³⁹ The Tribunal Judges further examined the rule that prevented losses of a UK branch of a non-resident company to be surrendered to a UK group company if any part of those losses corresponded to amounts deductible for foreign tax (section 403D(1)(c) Income and Corporation Taxes Act 1988, now repealed and replaced by section 107(5) and (6) CTA 2010). They found that the UK branch was objectively in a comparable situation to that of a UK subsidiary because the source state (here the UK) taxed them in the same way. On this basis, the limitation on group relief affected non-resident companies only and was therefore a restriction. *Philips Electronics*, fn.335, p.24. Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation v. Inland Revenue Commissioners* [2007] All ER (EC) 351 applied.

³⁴⁰ In relation to section 403D(1)(c) Income and Corporation Taxes Act 1988 (now repealed and replaced by section 107(5) and (6) CTA 2010), in case they were wrong and it was justified, the Tribunal Judges considered whether it was proportional. They followed the 'no possibilities' test as set out in *Marks & Spencer* and found that this provision did not satisfy it, being too draconian. Its 'all or nothing' stipulation (i.e. if any part of the loss could be used abroad, then none of the losses were available for group relief) went beyond what was necessary to prevent the double use of losses. It would have sufficed to preclude the use of losses as have actually been set off against foreign profits. This would have been a less restrictive interpretation. See *Philips Electronics*, above fn.335, pp.48–53.

3.3 Intra-group transfer of assets

3.3.1 UK rules

3.3.1.1. Broadly, under UK law, disposals of capital assets by one member of a group to another are treated as if made for a consideration that gives rise to neither gain nor loss.³⁴¹ In other words, intra-group transfers of assets are *prima facie* tax neutral within a group.

3.3.1.2. For capital gains purposes, a group consists of a principal company and all its 75% subsidiaries.³⁴² Second-tier 75% subsidiaries are also included in the group if they are effective 51% subsidiaries of the principal company.³⁴³ The principal company must be at the head of the corporate chain; a company cannot be a principal if it is a 75% subsidiary of another company.³⁴⁴

3.3.1.3. When there is an intra-group transfer of assets, the capital gains liability is postponed until the assets are disposed outside of the group³⁴⁵ or the company owning the assets leaves the (worldwide) group within six years of the transfer.³⁴⁶ If this happens, then the departing member is treated as having disposed of the asset and reacquired it at its market value at the time of that intra-group acquisition. In other words, there is a group exit charge.

3.3.1.4. So long as the asset remains within the UK tax net, transfers of assets are tax neutral, even if the members of the group are not all UK resident. This means that there is no capital gain liability if a UK subsidiary transfers assets to a non-UK subsidiary of the same parent *and* the asset is used by that non-UK subsidiary for its trade in the UK.³⁴⁷

3.3.1.5. It is obvious that the focus of the UK rules is on the intra-group transfer of chargeable *assets* and not the transfer of capital losses. Therefore, if a group company had capital losses to be absorbed, then chargeable assets had to be transferred to that company before being sold off to a third party.³⁴⁸ The legislation has now been amended to enable two companies in a group to elect to treat an asset as having been transferred to the loss-making company before being sold to person outside the group.³⁴⁹ The idea is to enable groups to bring together chargeable gains and allowable losses in a single company without the need to make an actual transfer of ownership of the asset within the group.³⁵⁰

3.3.1.6. The UK legislation contains a number of anti-abuse rules. The exit charge for a company leaving the group after six years from the intra-group

³⁴¹ Section 171 TCGA 1992.

³⁴² 75% subsidiaries are subsidiaries in which not less than 75% of their ordinary share capital is beneficially owned directly or indirectly by the principal company.

³⁴³ Section 170 TCGA 1992. A company is an effective 51% subsidiary of another company (the parent company) if the parent is entitled to more than 50% of any profits available for distribution to equity holders of the subsidiary and the parent would be entitled to more than 50% of any assets available for distribution to the equity holders on a winding up.

³⁴⁴ Section 170(4) TCGA 1992.

³⁴⁵ There is no exit charge if the transferee and transferor company leave the initial group but still form a sub-group of their own. However, they must be associated (i.e. capable of forming a group of their own) both at the time of the intra-group transfer *and* when they leave the group.

³⁴⁶ Section 179 TCGA 1992.

³⁴⁷ Sections 10 and 10B TCGA 1992.

³⁴⁸ This technique was used to enable the gain to materialise in the loss-making company and the losses to be set-off against that gain.

³⁴⁹ Section 101 Finance Act 2000.

³⁵⁰ Election must be made within two years of the end of the accounting period of the company that made the actual disposal (TCGA 1992, section 171A).

transfer has already been mentioned. Also, pre-entry capital losses are ring-fenced.³⁵¹ The legislation does not allow losses from depreciable transactions within a group to be realised on subsequent disposal of shares.³⁵² There are also provisions to prevent dividend stripping.³⁵³

3.3.1.7. Furthermore, there is a targeted anti-avoidance rule³⁵⁴ (TAAR) aimed at situations where a company changes ownership under arrangements the sole or main purpose of which was to secure a tax advantage by setting off gains and losses.

3.3.1.8. HMRC has powers to recover any unpaid tax from the principal member of the group, controlling directors and any other company that owned the asset in the 12 months prior to the gain accruing.³⁵⁵ The company assessed has the right to recover the tax from the chargeable company – including the right to recover any interest it has to pay.³⁵⁶

3.3.2. Intra-group transfers and reorganisations within the CCCTB

3.3.2.1. Broadly, capital gains and losses are recognised when incurred and the proceeds form part of the consolidated tax base.³⁵⁷ However, as mentioned in Part 2.4, under the draft CCCTB Directive, intra-group transfers are neutral within the consolidated tax base.³⁵⁸ The consolidated tax base does not include any profits or losses on intra-group transactions between members of the consolidated group. This means that only transactions between group and third parties or non-consolidated group companies would have any tax effect.

3.3.2.2. Under the original draft CCCTB proposal found in CCCTB57, gains on disposal of major shareholdings,³⁵⁹ whether in the EU or outside of the EU, were to be exempt.³⁶⁰ There was concern that the participation exemption would be used to present the sale of assets as a sale of shares, thus enabling the unrealised gain on the underlying assets to remain untaxed. In other words, in a consolidated group, assets could be located in one of the companies of the group (without the intra-group transaction being taxed) and the shares in this company could then be sold off without being taxed because of the participation exemption.³⁶¹

3.3.2.3. CCCTB57 contained a limited anti-abuse rule targeting this practice. It was proposed that 'gains realised on the disposal of such shares would not be exempted to the extent that assets were transferred to the departing company

³⁵¹ See sections 177A and Schedule 7A, 184A–184F TCGA 1992. Also see Finance Act 2007, which strengthens these anti-avoidance measures by providing that allowable capital losses do not include any losses that arise in consequence of arrangements designed to secure a tax advantage.

³⁵² Section 176 TCGA 1992. The disallowance is limited to the undervalue of a transaction. There is no reduction of gains or increase/creation of gains.

³⁵³ Section 177 TCGA 1992.

³⁵⁴ See sections 184A to 184F TCGA 1992.

³⁵⁵ Section 190 TCGA 1992. The gain must have accrued to a UK resident company and was within the charge to corporation tax.

³⁵⁶ *Ibid.*

³⁵⁷ See Art 17 of the draft CCCTB Directive.

³⁵⁸ Art 59.

³⁵⁹ A major shareholding is one where the recipient taxpayer has an interest in at least 10% of either capital or voting rights and the shareholding or participation is held for an uninterrupted period of at least 12 months. It is initially assumed that the shareholding would be held for 12 months. In the event that the holding is held for less than 12 months, the exemption is retrospectively reversed. CCCTB57, fn.20, paragraph 125 and fn.40. Also see analysis in Part 3.4.

³⁶⁰ CCCTB57, fn.20, paragraph 126.

³⁶¹ CCCTB/WP065\doc\en: 'CCCTB: Anti-Abuse rules' (14–15/04/2008) (henceforth CCCTB65), paragraph 35.

within the present or previous tax year and their disposal would have triggered a gain (possibly with the proviso that it is open to a taxpayer to demonstrate valid commercial reasons).³⁶²

3.3.2.4. The Commission had also suggested extending the rule to ensure that 'where a company leaves the group (or the group terminates) but without a sale of shares (e.g. the group does not renew the option after the initial five year period) in this case there could also be immediate taxation of the unrealised capital gains on assets that were transferred to the departing company within the present or previous tax year and their disposal would have triggered a gain'.³⁶³

3.3.2.5. Compared to the UK rules, the anti-abuse provisions of the CCCTB in this area were deemed to be much less complicated and perhaps inadequate. They seemed to target clear situations of abuse and the conditions for entitlement to the reliefs/exemptions were less onerous. Furthermore, the CCCTB technical discussion document at the time did not seem to contain any provisions for the ring-fencing of pre-consolidation gains and the taxation of hidden reserves. These issues were, to a great extent, addressed in the Commission's recent discussion document on reorganisations.³⁶⁴ In that document, the rules on reorganisations were tightened up, especially as regards the tax treatment of hidden reserves.

3.3.2.6. These rules are now adopted in the draft CCCTB Directive. It should be pointed out that under the draft CCCTB Directive *all* proceeds from disposal of shares are now exempt revenue,³⁶⁵ not just gains from disposals of major shareholdings. The draft CCCTB Directive stipulates, however, that where, as a result of a disposal of shares, a taxpayer leaves the group and that taxpayer has within the current or previous tax years acquired in an intra-group transaction one or more fixed assets other than assets depreciated in a pool, an amount corresponding to those assets are excluded from the exemption unless it is demonstrated that the intra-group transactions were carried out for valid commercial reasons.³⁶⁶ The General Anti-Abuse Rule (GAAR)³⁶⁷ can also be used when intra-group transfers of assets have the sole object of tax avoidance.³⁶⁸

3.3.2.7. Furthermore, the draft CCCTB Directive contains rules for pre-entry assets being disposed of by a group member within five years of entry into the group, to ensure the gains are attributed to the group member that held the economic ownership over these assets on the date entry.³⁶⁹ This claw-back ensures that the gains/losses are not added to the consolidated tax base. Instead

³⁶² CCCTB57, fn.20, paragraph 109. In a later discussion document, it was acknowledged that some Member States thought that the two years' holding period was too short and the rule would be easy to manipulate. CCCTB65, fn.362, paragraph 39.

³⁶³ *Ibid*, paragraph 37.

³⁶⁴ See CCCTB/RD\002, fn.9.

³⁶⁵ Art 11(d).

³⁶⁶ Art 75. The amount excluded from exemption shall be the market value of the asset or assets when transferred, less the value for tax purposes of the assets or the costs referred to in Article 20 relating to fixed assets not subject to depreciation. When the beneficial owner of the shares disposed of is a non-resident taxpayer or a non-taxpayer, the market value of the asset or assets when transferred less the value for tax purposes shall be deemed to have been received by the taxpayer that held the assets prior to the intra-group transaction referred to in the first paragraph. This provision seems to follow also from the discussion document on CCCTB anti-abuse issues, which contained rules dealing with the manipulation of the asset factor. See rule (vi) in CCCTB/RD\004, fn.9, paragraphs 27–29.

³⁶⁷ See analysis in Part 6.1.

³⁶⁸ *Ibid*. Also see CCCTB/RD\004, fn.9, paragraph 29.

³⁶⁹ Art 61 of the draft CCCTB Directive. The fixed assets covered by this rule are non-depreciable and individually depreciable (fixed assets), including financial assets with the exception of shares in affiliated undertakings, participating interests and own shares. Also see CCCTB/RD\002, fn.9, paragraph 7.

they increase the share apportioned to the group member that held the economic ownership over these assets at the time they joined the group.

3.3.2.8. Conversely, if assets are disposed of within three years of the departure from the group of the taxpayer holding the economic ownership over these assets, the proceeds will be added to the consolidated tax base of the group in the year of disposal and the costs relating to non-depreciable assets and the value for tax purposes of depreciable assets will be deducted.³⁷⁰

3.3.2.9. There are also special rules for self-generated intangible assets. Where a taxpayer, which is the economic owner of one or more self-generated intangible assets, leaves the group, an amount equal to the costs incurred in respect of those assets for research, development, marketing and advertising in the previous five years will be added to the consolidated tax base of the remaining group members.³⁷¹

3.3.2.10. The new draft CCCTB Directive clarifies that a business reorganisation within a group or the transfer of the legal seat of a taxpayer, which is a member of a group does not give rise to profits or losses for the purposes of determining the consolidated tax base.³⁷² However, where, as a result of a business reorganisation or a series of transactions between members of a group within a period of two years, substantially all the assets of a taxpayer are transferred to another Member State and the asset factor is substantially changed, different rules will apply.³⁷³ In the five years that follow the transfer, the transferred assets shall be attributed to the asset factor of the transferring taxpayer as long as a member of the group continues to be the economic owner of the assets. If the taxpayer no longer exists or no longer has a permanent establishment in the Member State from which the assets were transferred it shall be deemed to have a permanent establishment there.

3.3.2.11. These are welcome developments. However, further guidance as to the application of these anti-abuse rules regarding reorganisations appears to be needed. The time limitations seem to be arbitrary (some being five years and others three) and there were calls following the release of the reorganisations discussion document for these time limitations to be aligned.³⁷⁴

3.3.2.12. Another point raised is that some of the rules relating to reorganisations, as anti-abuse rules, appear to go beyond the *Cadbury Schweppes* test of wholly artificial arrangements. Whilst to an extent the rules provide for the allocation of taxing rights, they still ought to be exercised proportionally. As regards the GAAR and the specific anti-abuse rules, such as the rule for avoiding the manipulation of the asset factor featuring in the Commission's recent anti-abuse discussion document³⁷⁵ now enshrined in Art 75 of the draft CCCTB Directive,³⁷⁶ there is an escape clause on the basis of commercial justification. It would have been preferable if such an escape clause was also inserted in the

³⁷⁰ Art 67 of the draft CCCTB Directive. Again, the rule applies to financial assets, with the exception of shares in affiliated undertakings, participating interests and own shares. Also see CCCTB/RD\002, fn.9, paragraph 12.

³⁷¹ Art 68 of the draft CCCTB Directive. The amount added cannot, however, exceed the value of the assets on the departure of the taxpayer from the group. Also see CCCTB/RD\002, fn.9, paragraph 13.

³⁷² Art 70(1) of the draft CCCTB Directive.

³⁷³ Art 70(2).

³⁷⁴ See commentary by Business Europe Task Force on Commission document CCCTB/RD\002 and commentary by European Business Initiative on Taxation (EBIT), Part 2.

³⁷⁵ Rule (vi) in CCCTB/RD\004, fn.9, paragraphs 27–29, mentioned above.

³⁷⁶ This provision is part of the rules of Chapter XII on 'Dealings between the group and other entities' rather than within the rules of Chapter XIV on 'Anti-abuse rules'.

specific anti-abuse rules dealing with reorganisations.³⁷⁷ There is no logical explanation for this inconsistency.

3.3.2.13. In any case, however, it would seem that even with these refinements, the CCCTB provisions on intra-group transfers of assets are less complicated than the UK ones. However, they also appear to be more vague – and possibly open to manipulation.

3.4 Participation exemption

3.4.1. Under strict conditions, companies are exempt from UK tax on any gains arising from the disposal of substantial shareholdings in certain companies.³⁷⁸ On the other hand, any loss made on the disposal of a substantial shareholding does not give rise to an allowable capital loss.³⁷⁹ No claim is required for this exemption. If the conditions for the relief are met, the gain is exempt.

3.4.2. A substantial shareholding is defined as one where the company holds at least 10% of the company's ordinary share capital and is entitled to at least 10% of the profits available for distribution to equity holders and at least 10% of the company's assets available for distribution on winding up, throughout a 12-month period beginning no more than two years before the day on which the disposal takes place.³⁸⁰

3.4.3. There must be a disposal by a trading company (or a member of a trading group) of all or part of a substantial shareholding in another trading company (or the holding company of a trading group or sub-group). The trading requirement must be satisfied during the qualifying period and immediately after the disposal.³⁸¹ There is no requirement for the company invested in or the investing company to be UK resident companies.³⁸² Likewise, the trade need not be carried on in the UK.

3.4.4. The exemption is extended to gains accruing to a company on a disposal of an asset related to substantial shareholdings in another company.³⁸³

3.4.5. These two exemptions, i.e. the exemption for shares and the exemption for assets related to shares, are not available where an 'untaxed' gain accrues to the investing company on a disposal of shares (or an asset related to shares) in another company and before the accrual of that gain, the investing company had just acquired control of the company invested in or there was a significant change of trading activities when the investing company acquired control of that

³⁷⁷ As explained in Part 6.1, under the new CCCTB anti-abuse paper, the GAAR and its commercial justification test would only apply if the potentially abusive practice did not fall within the scope of any of the specific rules (CCCTB/RD\004, fn.9, paragraph 9). Even though the specific rules relating to reorganisations were not included in the anti-abuse paper but rather in the reorganisation paper, there was no reason why these rules would not take precedence over the GAAR as the other rules. As the draft CCCTB Directive does not provide an express hierarchy between the GAAR and specific anti-abuse rules (see commentary in 6.1.10), it is not certain whether this analysis still applies.

³⁷⁸ Schedule 7AC, paragraph 1 TCGA 1992

³⁷⁹ The general rule in section 16(2) TCGA 1992 applies, in that where a gain is not a chargeable gain, a loss is not an allowable loss.

³⁸⁰ Schedule 7AC, paragraphs 8–10 TCGA 1992.

³⁸¹ Schedule 7AC, paragraphs 18–27 TCGA 1992.

³⁸² Also, where group structures are relevant for either the investing company or the company invested in, the group is not limited to the UK resident members.

³⁸³ Schedule 7AC, paragraphs 2 and 6(2) TCGA 1992.

company *and* these circumstances occurred in pursuance of an arrangement for which the sole or main benefit was to get the exemption.³⁸⁴

3.4.6. As mentioned above, CCCTB57 contained a participation exemption,³⁸⁵ which was subsequently subsumed by the general exemption of proceeds from the disposal of shares under the draft CCCTB Directive.³⁸⁶ This exemption is qualified by Art 75, which broadly provides for the disallowance of exempt share disposals unless they are carried out for valid commercial reasons. Therefore, the participation exemption under the draft CCCTB Directive is much broader than UK participation exemption and subject to much vaguer anti-abuse provisions. There is no minimum shareholding, no minimum amount, no minimum ownership period, no requirement for trading activities etc. This feature of the CCCTB may prove to be very attractive for multinationals.

3.5 Administration

3.5.1 UK rules

3.5.1.1. Under UK law, groups can arrange to pay corporation tax on a group basis. A nominated member company enters into a binding agreement with HMRC pursuant to which it undertakes to pay the corporation tax liability of all or some of the companies in the specified group. Under these arrangements, each company's liability is met out of an allocation of the group payment made. A group, for these purposes, is a company and all its 51% subsidiaries.³⁸⁷ There may be several group payment arrangements within one large group.

3.5.1.2. It should be emphasised that a group payment arrangement transfers the responsibility for making payments to the nominated company and *not* the actual tax liability of the participating companies. Group members still have to file individual self-assessment returns separately and each company needs to compute its own corporation tax liability for the accounting period. Interest on underpaid tax remains the liability of the individual group company, as will any late fine or penalty that may be incurred.

3.5.1.3. Similarly, as seen above, for group relief purposes, a group can enter into arrangements with HMRC to enable claims and consents to be made in a single document, the joint amended return.³⁸⁸

³⁸⁴ Section 288(1), Schedule 7AC, paragraph 5 TCGA 1992.

³⁸⁵ Gains on disposal of major shareholdings, whether in the EU or outside of the EU, were exempt. It was initially assumed that the shareholding would be held for 12 months. In the event that the holding was held for less than 12 months, the exemption would be retrospectively reversed. CCCTB57, fn.20, paragraph 125 and fn.40. The conditions for this exemption were quite similar to the UK substantial shareholders' exemption. A major shareholding was also defined in terms of 10% ownership/interest in the capital or voting rights of another company, which needed to be held for an uninterrupted period of at least 12 months. Similar to the UK rules, there was no need for the investing company or the company invested in to be resident in the same jurisdiction. One important difference, however, was that the proposed CCCTB rules did not require the company making the disposal of the major shareholding to be a trading company (or a member of a trading group). Nor did they require that the major shareholding be held in a trading company (or the holding company of a trading group or sub-group). Therefore, to an extent, the participation exemption under the CCCTB was more accessible than the UK's substantial shareholders' exemption.

³⁸⁶ See discussion in Part 3.3.2.

³⁸⁷ See section 36 Finance Act 1998. The whole tier can benefit from these arrangements, as long as each company in the tier owns more than 50% of the equity capital in the company at the tier below it.

³⁸⁸ Simplified arrangements under Corporation Tax (Simplified Arrangements for Group Relief) Regulations 1999 (SI1999/2975).

3.5.1.4. All of the above are merely rules providing some administrative convenience to groups in so far as the payment of their taxes is concerned. They are not compulsory and they do not remove the separate obligations of the group companies. Therefore, in so far as the administrative obligations of group companies are concerned, UK companies function to a large extent as independent entities, severally liable.

3.5.2 Administration under the CCCTB

3.5.2.1. The arrangement could not have been more different under the draft CCCTB Directive, which follows a one-stop shop approach.³⁸⁹ The aim is for groups of companies to be able to deal with a single tax administration (the principal tax authority), which should be that of the Member State in which the parent company of the group (the principal taxpayer) is resident for tax purposes.³⁹⁰ Both terms are defined in Art 4 of the draft CCCTB Directive.³⁹¹

3.5.2.2. The overall administration of the CCCTB had been laid down in CCCTB61.³⁹² Broadly, each group company would follow national rules to keep financial accounts. These would be adjusted to the CCCTB if the membership/consolidation test was satisfied and the group had elected to become a CCCTB group. Following this, CCCTB tax accounts of consolidated group members would be forwarded to the principal taxpayer, where they would be consolidated. The principal taxpayer would file the consolidated tax return of the group with the principal tax authority. Audits would be initiated and co-ordinated by the principal tax authority (also on request by another competent authority), which would also compile the results of the audits. There are provisions in place for appealing the decisions of the principal tax authority.

3.5.2.3. Detailed rules on the administration of the system are now set out in Chapter XVII of the draft CCCTB Directive, which largely follows CCCTB61. Notice to opt to become a CCCTB group is given by the principal taxpayer to the principal tax authority,³⁹³ which shall transmit the notice immediately to the competent authorities of all Member States in which the group members are resident or established.³⁹⁴ When the notice to opt has been accepted, it will be binding for five tax years.³⁹⁵ Following the expiry of that initial term, the group

³⁸⁹ See Chapter XVII of the draft CCCTB Directive and CCCTB/WP061\doc\en: 'CCCTB: Possible Elements of the Administrative Framework' (13 November 2007) (henceforth CCCTB61). Also see Ernst Czakert, 'Administrative Issues and CCCTB' [2008] 4 *EC Tax Review* 169.

³⁹⁰ See Preamble to the draft CCCTB Directive, para 23.

³⁹¹ Under Art 4(6) of the draft CCCTB Directive, 'principal taxpayer' means (a) a resident taxpayer, where it forms a group with its qualifying subsidiaries, its permanent establishments located in other Member States or one or more permanent establishments of a qualifying subsidiary resident in a third country; or (b) the resident taxpayer designated by the group where it is composed only of two or more resident taxpayers which are immediate qualifying subsidiaries of the same parent company resident in a third country; or (c) a resident taxpayer which is the qualifying subsidiary of a parent company resident in a third country, where that resident taxpayer forms a group solely with one or more permanent establishments of its parent; or (d) the permanent establishment designated by a non-resident taxpayer which forms a group solely in respect of its permanent establishments located in two or more Member States. It should be pointed out that the principal taxpayer designated in accordance with Art 4(6) may not be subsequently changed, unless there are exceptional circumstances, or where the principal taxpayer ceases to meet the criteria of Art 4(6). Under Art 4(22), 'principal tax authority' means the competent authority of the Member State in which the principal taxpayer is resident or, if it is a permanent establishment of a non-resident taxpayer, is situated.

³⁹² See fn.9.

³⁹³ Art 104(1) of the draft CCCTB Directive.

³⁹⁴ Art 104(3). Within one month of the transmission, the other authorities may submit to the principal tax authority their views and any relevant information on the validity and scope of the notice to opt. The competent authority to which the notice to opt is validly submitted shall examine whether, on the basis of the information contained in the notice, the group fulfils the requirements of the Directive. Art 107(1).

³⁹⁵ Art 105(1).

will continue to apply the new tax base, unless it gives notice of termination.³⁹⁶ There are rules for when a taxpayer joins or leaves a group,³⁹⁷ the information needed in the notice to opt,³⁹⁸ as well as the calculation of the tax year.³⁹⁹

3.5.2.4. The consolidated tax return is to be filed by the principal taxpayer with the principal tax authority.⁴⁰⁰ The return shall be treated as an assessment of the tax liability of each group member.⁴⁰¹ There are rules prescribing the contents of the tax return,⁴⁰² the notification of errors in the tax return⁴⁰³ and rules on electronic filing, tax returns and supporting documentation.⁴⁰⁴ Where the principal taxpayer fails to file a consolidated tax return, the principal tax authority will issue an assessment within three months based on an estimate, taking into account all available information. This can be appealed by the principal taxpayer.⁴⁰⁵ There are also provisions for amended assessments.⁴⁰⁶ Subject to a *de minimis* rule,⁴⁰⁷ the principal taxpayer, following consultation with the other relevant competent authorities,⁴⁰⁸ may issue an amended assessment no later than three years⁴⁰⁹ after the final date for filing the consolidated corporate tax return. A group member's competent authority may also call on the principal tax authority to issue an amended assessment, though there does not appear to be an obligation for the latter to act on it.⁴¹⁰

3.5.2.5. An important feature of the new system is the sharing of information between competent authorities. The consolidated tax return and supporting documents filed by the principal taxpayer will be stored on a central data base to which *all* the competent authorities will have access.⁴¹¹ The central data base will be regularly updated with all further information and documents, and all decisions and notices issued by the principal tax authority. CCCTB companies are under an obligation to keep records and supporting documents in sufficient detail to ensure the proper implementation of the Directive and to allow audits to be carried out.⁴¹² Furthermore, when requested by the principal tax authority, the principal taxpayer has to provide all information relevant to the determination of the consolidated tax base or the tax liability of any group members.⁴¹³ This is in addition to the power of the competent authorities of any group member to request from it all information relevant to the determination of its tax liability.⁴¹⁴ All information communicated between competent authorities on matters relating to the Directive will, to the extent possible, be provided by

³⁹⁶ *Ibid.*

³⁹⁷ Art 105(2) and (3).

³⁹⁸ Art 106.

³⁹⁹ Art 108.

⁴⁰⁰ Art 109(1).

⁴⁰¹ Art 109(2).

⁴⁰² Art 110. The principal tax authority verifies that the consolidated tax return complies with these requirements. See Art 114(2).

⁴⁰³ Art 111.

⁴⁰⁴ Art 113.

⁴⁰⁵ Art 112.

⁴⁰⁶ Art 114.

⁴⁰⁷ No amended assessment can be issued where (1) the difference between the declared consolidated base and the corrected base does not exceed the lower of EUR 5,000 or 1% of the consolidated tax base and (2) the total of the apportioned shares of the group members resident or established in a Member State would be adjusted by less than 0.5%. Art 114(7).

⁴⁰⁸ Art 114(6) of the draft CCCTB Directive.

⁴⁰⁹ Art 114(3). When there is deliberate or grossly negligent misstatement on the part of the taxpayer, or the misstatement is the subject of criminal proceedings, the amended assessment may be issued within 6 or 12 years respectively. Art 114(5).

⁴¹⁰ Art 114(6).

⁴¹¹ Art 115.

⁴¹² Art 117.

⁴¹³ Art 118.

⁴¹⁴ *Ibid.*

electronic means, by making use of the common communication network/common system interface (CCN/CSI).⁴¹⁵

3.5.2.6. The draft CCCTB Directive provides for an advance ruling mechanism. A taxpayer (i.e. any company that has opted to apply the CCCTB,⁴¹⁶ not necessarily the principal taxpayer) can request an opinion by the competent authority of the Member State in which it is resident or has a permanent establishment 'on the implementation of the Directive to a specific transaction or series of transactions planned to be carried out'.⁴¹⁷ It can also request an opinion regarding the proposed composition of the group. The competent authority has to take all possible steps to respond to the request within a reasonable time.⁴¹⁸

3.5.2.7. Provided that all relevant information concerning the planned transaction or series of transactions is disclosed, the opinion issued by the competent authority will be binding on it. This is subject to the caveat that the courts of the Member State of the principal tax authority may subsequently decide otherwise.⁴¹⁹ Also, if the taxpayer disagrees with the opinion, it may act in accordance with its own interpretation but must draw attention to that fact in its tax return or consolidated tax return.⁴²⁰ The competent authorities of more than one Member States can agree on a common opinion, where two or more group members in different Member States are directly involved in a specific transaction or a series of transactions, or where the request concerns the proposed composition of a group.⁴²¹

3.5.2.8. There is also a secrecy clause. The starting point is that all information made known to a Member State under this Directive shall be kept secret in that Member State in the same manner as information received under its domestic legislation.⁴²² In any case, such information may be made available only to the persons directly involved in the assessment of the tax or in the administrative control of this assessment.⁴²³ The information may also be made known only in connection with judicial/administrative proceedings involving sanctions undertaken relating to the tax assessment and only to persons who are directly involved in such proceedings.⁴²⁴ In no circumstances can the information be used other than for taxation purposes or in connection with such judicial/administrative proceedings.⁴²⁵ However, the competent authority of the Member State providing the information may permit it to be used for other purposes in the requesting State, if under the legislation of the informing State, the information could be used there for similar purposes.⁴²⁶

3.5.2.9. As far as audits are concerned, they may be initiated and co-ordinated by the principal tax authority but the authorities of any Member State in which a group member is subject to tax may request the initiation of an audit.⁴²⁷ The principal tax authority and the other competent authorities will jointly determine

⁴¹⁵ Art 120.

⁴¹⁶ Art 4(1).

⁴¹⁷ Art 119(1).

⁴¹⁸ *Ibid.*

⁴¹⁹ The procedure for disagreement is set out in Art 123.

⁴²⁰ *Ibid.*

⁴²¹ Art 119(2).

⁴²² Art 121.

⁴²³ Art 121(1)(a).

⁴²⁴ Art 121(1)(b).

⁴²⁵ Art 121(1)(c).

⁴²⁶ Art 121(2).

⁴²⁷ Art 122(1).

the audit and the group members to be audited.⁴²⁸ The audit will be conducted in accordance with the national legislation of the Member State in which it is carried out, subject to the required adjustments under the draft CCCTB Directive.⁴²⁹ The principal tax authority will compile the results of the audits.⁴³⁰ Therefore, the audit is centralised and no time limits are set out.

3.5.2.10. The competent authority of the Member State in which a group member is resident or established may challenge a decision of the principal tax authority concerning the notice to opt or an amended assessment before the courts of the Member State of the principal tax authority within a period of three months, having the same procedural rights as a taxpayer of that Member State in proceedings against a decision of the principal tax authority.⁴³¹

3.5.2.11. A principal taxpayer may appeal against a number of acts such as a decision rejecting a notice to opt, a notice requesting the disclosure of documents or information, an assessment on the failure to file a consolidated tax return etc.⁴³² Such appeal will not have any suspensory effect on the tax liability of a taxpayer.⁴³³

3.5.2.12. Appeals against amended assessments or assessments for failure to file a tax return will be dealt with by an administrative body, which is competent to hear appeals at first instance according to the law of the Member State of the principal tax authority. If there is no such competent body, then the taxpayer may lodge directly a judicial appeal.⁴³⁴ CCCTB61 had provided for the disputes to be decided by an arbitration panel made up of three to five experts from a list drawn up by common agreement of the Member States.⁴³⁵ This detail is not included in the draft CCCTB Directive, though it may presumably be devised by the committee to be set up by the Commission under Art 131 of the draft CCCTB Directive.

3.5.2.13. The principal tax authority has to act in close consultation with the other competent authorities in making submissions to the administrative body.⁴³⁶ The administrative body may require further information to be provided by the principal taxpayer and the principal tax authority on the group and its associated enterprises, assisted by competent authorities of other Member States if necessary.⁴³⁷ The administrative body can vary the decision of the principal tax authority,⁴³⁸ but it has to decide the appeal within six months.⁴³⁹ Failure to do so means that the decision of the principal tax authority is deemed to have been confirmed.⁴⁴⁰

3.5.2.14. Where this decision is confirmed or varied, the principal taxpayer has the right to appeal directly to the courts of the Member State of the principal tax authority within 60 days of the receipt of the decision of the administrative

⁴²⁸ *Ibid.*

⁴²⁹ Art 122(2).

⁴³⁰ Art 122(3).

⁴³¹ Art 123.

⁴³² See Art 124(1). The appeal has to be lodged within 60 days of the receipt of the act appealed against.

⁴³³ Art 124(3).

⁴³⁴ Art 125(1).

⁴³⁵ CCCTB61, fn. 9, paragraphs 43–45.

⁴³⁶ Art 125(2) of the draft CCCTB Directive.

⁴³⁷ Art 125(3).

⁴³⁸ Art 125(4).

⁴³⁹ Art 125(5).

⁴⁴⁰ *Ibid.*

appeals body.⁴⁴¹ Where the decision is annulled, the administrative body will remit the matter to the principal tax authority, which will take a new decision within 60 days.⁴⁴²

3.5.2.15. A judicial appeal against a decision of the principal tax authority will be governed by the law of the Member State of that principal tax authority.⁴⁴³ CCCTB61 had stipulated that judicial appeals would cover points of CCCTB law and encompass judicial appeals made by the principal taxpayer against the consolidated assessment.⁴⁴⁴ The draft CCCTB Directive is less prescriptive on this point. Again, in making submissions to the courts, the principal tax authority acts in consultation with the other competent authorities.⁴⁴⁵ The national court may order further evidence to be provided by the principal taxpayer and the principal tax authorities, assisted by other competent authorities.⁴⁴⁶

3.5.2.16. A few issues arise from the administration provisions of the draft CCCTB Directive.

3.5.2.17. First, it is obvious that the draft CCCTB Directive provides an extensive mechanism for the sharing of information. As shown above, it contains detailed provisions for communication of information between competent authorities and requests for co-operation and exchange of information.⁴⁴⁷ To an extent, it would seem that the CCCTB's information sharing mechanisms go beyond the existing mechanisms of administrative co-operation in the field of direct taxes (e.g. tax treaties and Directive 77/799). However, as these existing mechanisms are about to be eclipsed following the adoption of the much more expansive EU Council Directive 2011/16/EU on exchange of information, this different approach may be temporary. The latter Directive provides, *inter alia*, for automatic exchange of information for specific categories of income⁴⁴⁸ and for the disclosure of information and documents under specific circumstances⁴⁴⁹ and subject to rather limited safeguards.⁴⁵⁰ Furthermore, under specific circumstances, information by a Member State from a third country may be transmitted to other Member States.⁴⁵¹

3.5.2.18. Juxtaposed with the provisions of the draft CCCTB Directive, some interesting analogies arise. For example, the centralised database and the overall structure of Chapter XVII of the draft CCCTB Directive suggest that the flow of information under it is likely to be continuous and automatic, rather than ad hoc and subject to isolated requests.⁴⁵² The new Directive on exchange of information 2011/16/EU appears to be aligned with this approach.

3.5.2.19. Furthermore, onward transmission of third country information is a possibility under both the new Directive on exchange of information and the

⁴⁴¹ Art 125(6).

⁴⁴² Art 125(7).

⁴⁴³ Art 126(1).

⁴⁴⁴ CCCTB61, paragraphs 65–67.

⁴⁴⁵ Art 126(2) of the draft CCCTB Directive.

⁴⁴⁶ Art 126(3).

⁴⁴⁷ See Art 120(1) pursuant which all information communicated under the Directive will, to the extent possible, be provided by electronic means, by using the common communication network/common system interface (CCN/CSI).

⁴⁴⁸ Art 8 of Directive 2011/16/EU.

⁴⁴⁹ Art 16 of Directive 2011/16/EU.

⁴⁵⁰ Art 17 of Directive 2011/16/EU.

⁴⁵¹ Art 24 of Directive 2011/16/EU.

⁴⁵² Also see analysis by Adolfo Martin Jimenez/Jose Manuel Calderon Carrero, 'Administrative Co-operation – Exchange of Information in the Context of the Common Consolidated Corporate Tax Base', in Lang et al., fn.18, p.903.

draft CCCTB Directive. Under the draft CCCTB Directive, an amended assessment can be issued in compliance with, *inter alia*, 'the result of a mutual agreement or arbitration procedure with a third country'.⁴⁵³ This suggests – though again it is not made clear – that information received by third countries may be shared with other Member State competent authorities. As rights and obligations arising from DTCs with third countries appear to take precedence over the CCCTB,⁴⁵⁴ this is unlikely to override third countries' rights under the exchange of information article of their DTCs. However, the (inadvertent) disclosure of information as a result of the sharing of information between competent authorities remains a possibility. The risk of such disclosure is much higher for potential non-CCCTB Member States whose rights and obligations are much more likely to be subordinated to the CCCTB, as a result of enhanced co-operation. When the new Directive on exchange of information enters into force, such onward transmission of information even from third countries may become less contentious.

3.5.2.20. Arguably, it appears to be assumed that Directive 2011/16/EU will be applicable when implementing the provisions of the draft CCCTB Directive.⁴⁵⁵ Therefore, where possible and necessary, the exchange of information and co-operation provisions of the CCCTB may be buttressed by the Member States' powers under the new Directive on exchange of information.

3.5.2.21. Another issue arising is whether the secrecy clause of the draft CCCTB Directive goes far enough to ensure that the principle of confidentiality is protected and that secrecy safeguards are preserved. Arguably, the secrecy clause is rather obscure on when the common information can be disclosed and how it can be used. For example, Art 121(1)(a) of the draft CCCTB Directive provides that information made known to a Member State 'may be made available only to persons directly involved in the assessment of the tax [...]'. Are these directly involved persons only tax officials and, if so, from which Member State? Within a multinational CCCTB group, many persons can be perceived to be directly involved. Therefore, it would appear that there are not enough safeguards in this provision. Also, Art 121(1)(c) of the draft CCCTB Directive provides that 'in no circumstances [can the information] be used other than for taxation purposes [...]'. Again, this is very general. Does it cover the specific CCCTB tax assessment only or also other taxes? Are there any time limitations? Generally, there appears to be nothing to prevent the common CCCTB information from being transmitted to a tax authority outside the CCCTB system and/or from being used for other tax purposes now or in the future.

3.5.2.22. This is likely to raise concerns for the protection of taxpayers' rights under the CCCTB. As a corollary, it is also likely to raise demands for the more effective participation of taxpayers in the running of the system and the availability of effective remedies. One way of meeting some of these concerns is for the competent authorities of all Member States to set up designated CCCTB units, which will be uniquely involved in the application of the CCCTB and will have exclusive access to CCCTB information. It would also be helpful if the Commission adopted further guidelines on some of these important issues

⁴⁵³ Art 114(4) of the draft CCCTB Directive. There is a longer, 12-month period for such amended assessments.

⁴⁵⁴ See Art 8 of the draft CCCTB Directive, which stipulates that '[t]he provisions of this Directive shall apply notwithstanding any provision to the contrary in any agreement concluded between Member States'. This implies that the draft CCCTB Directive would not override existing DTCs with third countries. Also see analysis in Part 5 below.

⁴⁵⁵ See Art 120(2) of the draft CCCTB Directive, which provides that requests for co-operation or exchange of information under Directive 2011/16/EU, have to be dealt with no later than three months from the date of receipt of the request.

pertaining to the effective functioning of the CCCTB administration (e.g. taxpayer rights, limits to the use of CCCTB information, common audit guidelines etc.).⁴⁵⁶

3.5.2.23. Even though the problematic features of the CCCTB administration were raised and criticised⁴⁵⁷ ever since the publication of the initial discussion document on administrative issues (CCCTB61), none of these were considered further by the Commission and no additional clarifications released prior to the publication of the draft CCCTB Directive. This is very unfortunate and could prove to be a deal-breaker for any proposal. For, even if the Commission designs the perfect CCCTB, if the administration of it is obscure, arbitrary, without sufficient safeguards and/or subject to heavy regulation promulgated under the Comitology procedure, then the attractiveness of the CCCTB will be substantially eroded.

3.6 Conclusions

3.6.1. As the CCCTB is elective, technically, the UK tax rules are unlikely to be affected by the new tax base, regardless of whether the UK opts in or out of it. If the UK decides not to adopt the CCCTB, then its existing tax base will remain in place and the CCCTB will be treated as any other foreign tax base.⁴⁵⁸ Technically, there will be no interaction between the two bases *within* the UK. There will be interaction at international level, as with any other foreign tax systems. The interaction of the UK tax base and the CCCTB as a foreign tax base is considered in greater detail below.⁴⁵⁹

3.6.2. Nevertheless, even if the CCCTB is not adopted in the UK, it is still essential to compare some of the constituent elements of the CCCTB proposal with the UK system, as was briefly done in this report. These are the very elements that tend to influence multinational companies in their tax planning. One important element is the common tax base, which was analysed above.⁴⁶⁰ Consolidation and, as a corollary, cross-border loss relief are other important features of the CCCTB. It was argued that the CCCTB is much more permissive than the UK group relief rules. Cross-border losses of consolidated subsidiaries or permanent establishments are automatically set off against the consolidated profits.

3.6.3. However, the CCCTB regime does not have the flexibility of the UK group relief system. Under the CCCTB regime, losses are locked in for CCCTB group members and carried forward indefinitely. Contrary to the situation under the UK rules, the consolidated group company has no choice as to whether it will surrender its losses, how much of them and to which group company. To an extent, this is a commitment imposed on consolidated group companies when the group becomes a CCCTB group.

3.6.4. The same argument goes in so far as the intra-group transfer of assets is concerned. Although in both areas the UK system is more flexible and of a voluntary nature compared to the CCCTB, nevertheless, it is buttressed by such

⁴⁵⁶ For criticisms and suggestions, see generally, Jimenez & Carrero, fn.452 and Klaus-Dieter Druen, 'Tax Audit of Multinational Enterprises – Challenges and Chances in the Era of a Common Consolidated Corporate Tax Base', Lang et al., fn.18, p.1043.

⁴⁵⁷ For an excellent analysis of some of these issues, see contributions in Part IX, Lang et al., fn.18.

⁴⁵⁸ The interaction of the UK tax base and the CCCTB as a foreign tax base is considered in greater detail in Part 5, which looks at the international issues.

⁴⁵⁹ See Part 5.

⁴⁶⁰ See Part 2.3.

complex anti-abuse rules that it makes it more onerous for group companies to qualify for the reliefs.

3.6.5. One of the major dissimilarities identified was in the administration of the two systems. As expected from a national tax base, the administration of it is strictly territorial. All audits, assessments, appeals, penalties are dealt with by HMRC. Even the grant of relief for overseas losses is supervised and sanctioned by HMRC. Co-operation with other authorities is limited to exchange of information and mutual assistance (though this may change when the new Directive on exchange of information 2011/16/EU enters into force). By contrast, the administration of the CCCTB is on a completely different level: it is supra-national. The financial and tax reporting functions of the group are centralised and incumbent upon the principal taxpayer. So are, as a corollary, the tax authorities' functions. Co-operation between tax authorities is essential to the smooth running of the system. Furthermore, dispute resolution becomes more centralised.

3.6.6. However, the decision to opt in or out of the CCCTB should not be taken lightly. Although the decision is likely to be a political one, the UK government ought to reflect on the differences between the two systems, so as to anticipate as much as it is possible whether staying outside of the CCCTB zone will bring about a competitive disadvantage to the UK.

3.6.7. What if the UK adopts the CCCTB? Will it get the best of both worlds; i.e. the CCCTB option, whilst still preserving the UK tax base? This is considered in the next part of this report.

4. Adoption of the CCCTB in the UK

4.1. If the UK decides to adopt the CCCTB, then it would have a choice of adopting it as its sole tax base or as an alternative tax base to the existing one.

4.2. If the CCCTB becomes the sole tax base, the issue of adjusting from the UK GAAP to the CCCTB would still exist. Currently, the proposal contains no bridging rules. Furthermore, if the UK tax base is replaced by the CCCTB, then the transitional problems of moving from the existing tax base to the CCCTB would be many, both for the UK and for entities moving between the two systems. For example, would exit tax rules be triggered when a group becomes a CCCTB group? What about transferred assets held by companies becoming CCCTB companies? What would happen to hidden reserves?

4.3. Domestic tax incentives would no longer be available to companies as these are not deductible under the CCCTB. What would happen, then, to the capital allowances that a company claims before there is a switch to the CCCTB? Similar issues seem to arise whether the UK adopts the CCCTB as its only tax base or as an additional tax base.

4.4. The possibility of the UK (or any other Member State for that matter) adopting the CCCTB as its sole tax base is very limited. Therefore, this part of the report focuses on the more realistic situation whereby the CCCTB exists in parallel with the national tax base.

4.5. First, it should be acknowledged that the two tax bases would effectively be in competition with each other. The previous part of this report looked at some of the many differences between the UK rules and the CCCTB. Arguably, if both sets of rules are available simultaneously, then the opportunities for arbitrage are likely to increase.

4.6. For example, a profitable UK parent company with loss-making foreign subsidiaries may choose to become a CCCTB group in order to benefit from full consolidation rather than struggle to satisfy the highly prescriptive tests of the UK legislation, post-*Marks & Spencer*, pending the Commission's infringement action.⁴⁶¹

4.7. Similarly, if a loss-making group company wants to sell assets transferred to it intra-group to a person outside of the group, then it may choose the CCCTB regime pursuant to which there is a shorter holding period⁴⁶² for the intra-group transfer to remain exempt.

4.8. Also, if a group company wants to sell its major shareholding in another group company, then it might choose to do so under the CCCTB regime, as there is no requirement for the selling company to be a trading company.

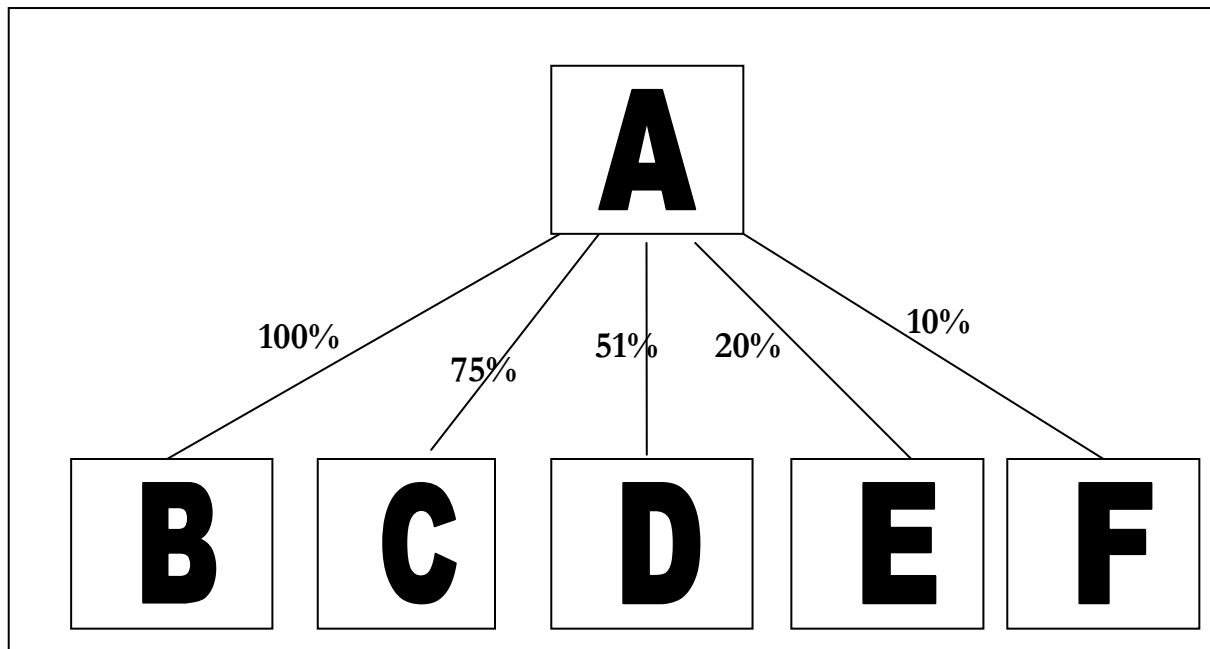
4.9. Nevertheless, the CCCTB regime and the UK rules may not always be mere alternatives; that is, two different systems to choose from. Given the threshold test adopted for membership and consolidation, there could be

⁴⁶¹ See Part 3.2.1.

⁴⁶² See Part 3.3.2.

situations where there is a UK group and a CCCTB group, co-existing as part of a larger group. Inevitably, there will be some overlaps in the sense of simultaneous application of regimes rather than conflicts.

4.10. Let us take as an example the following structure. It is assumed that all companies are in CCCTB Member States.



4.11. If an election to become a CCCTB group is exercised, then under the current draft rules,⁴⁶³ companies A, B and C will become CCCTB group companies and be automatically consolidated.

4.12. This means companies D, E and F will be subject to the UK rules and the UK tax base, with the option of applying the CCCTB rules (without consolidation) as well. However, under the CCCTB proposal, any associated companies⁴⁶⁴ that are not consolidated (here companies D and E) have to apply the arm's length principle in their dealings, regardless of whether the domestic regime has transfer pricing rules.⁴⁶⁵ Therefore, although the initial assumption is that anything in the CCCTB ought to be outside of the UK tax rules, there could certainly be situations such as this one where there are some overlaps.

4.13. There could also be situations where there is divergence of approach under the CCCTB rules and the UK tax rules. This is especially the case under the CCCTB anti-abuse rules, which are less complicated than the UK anti-abuse rules and only applicable vis-à-vis third countries.⁴⁶⁶ Let us take as an example the situation where a UK parent company has a CFC in a non-EU/EEA country. This UK parent company is a CCCTB company. The CFC rules of the CCCTB are triggered,⁴⁶⁷ but the escape clause is activated, as a result of a commercial justification. What if this commercial justification would not have sufficed for the purposes of the UK CFC rules? This could mean that there would

⁴⁶³ See Part 2.1.

⁴⁶⁴ See analysis in Part 2.5 above.

⁴⁶⁵ For the anti-abuse aspects, see Part 6.

⁴⁶⁶ See Part 6 below.

⁴⁶⁷ See analysis in Part 6.

be no attribution of profits from a CFC part of a CCCTB group but there would be such attribution if the CFC was not part of a CCCTB group. It is not certain whether the GAAR could be used to bridge the differences to ensure there is alignment with domestic rules.

4.14. A similar situation would arise if the UK parent company has a CFC in a non-CCCTB Member State. If the UK parent company is a CCCTB company, then the CFC rules would not apply to the CFC *ab initio* as this is not a CFC in a third country.⁴⁶⁸ As discussed in Part 6.1 below, it is not certain from the new CCCTB anti-abuse rules whether this means that the UK CFC rules would be triggered by default or whether a solution would be sought through the GAAR.

4.15. The same arguments are applicable to thin capitalisation structures involving a UK borrower company, which is a CCCTB company and its foreign lender. If the foreign lender is an associated enterprise in a third country,⁴⁶⁹ and there is a commercial justification, then interest may be deductible in situations where it would not have been deductible under the UK thin capitalisation rules.

4.16. Similarly, if the lender is a non-CCCTB Member State company, then arguably the CCCTB thin capitalisation rules are not applicable and interest may be deductible in situations where it would not have been deductible under the UK thin capitalisation rules. Again, it is not certain whether the UK rules will apply by default or whether the application of the GAAR will result in deference being paid to the domestic rules.

4.17. The anti-abuse rules are examined in greater detail in Part 6 below. As the UK is unlikely to adopt the CCCTB, it is important to consider these rules also in the context of the rules on outbound and inbound investment.

⁴⁶⁸ Under the revised CCCTB anti-abuse rules, the CFC rules are applicable vis-à-vis third country companies only. See Part 6.2.

⁴⁶⁹ See analysis in Part 6.3.

5. Inbound and outbound investment

5.1 General

5.1.1. If the UK does not adopt the CCCTB, even as an optional tax base, then the CCCTB would *prima facie* be treated as just another foreign tax base. So, from a UK perspective, inbound and outbound investment in the CCCTB area would be taxed in the same way as investment in any other foreign jurisdiction. This will be subject to possible caveats due to a general duty of EU loyalty and the duty of non-impediment under the enhanced co-operation procedure.⁴⁷⁰

5.1.2. However, from a CCCTB perspective, the rules on the taxation of inbound and outbound investment are somewhat different from conventional single country rules. Therefore, the UK may be affected in unanticipated ways. To that extent, these rules merit special attention.

5.1.3. When reference is made to inbound and outbound investment, in principle, it may be necessary to look at whether the investment originates from or is targeted in entities that are *outside* of the CCCTB area, *regardless of whether these entities are resident in a Member State or a third country*. However, as mentioned above, the Commission bases its proposal on the premise that there will not be non-CCCTB Member States. In other words, the underlying assumption of the current CCCTB proposal is that outbound and inbound investment can only refer to investment to and from third countries.

5.1.4. However, this appears to be an unrealistic assumption to make. There may very well be non-CCCTB Member States; i.e. investment to and from non-CCCTB countries *but* within the EU. It is important to consider whether, indeed, the tax treatment of inbound and outbound investment will be the same for non-CCCTB Member States (such as possibly the UK) and for third countries. It is also important to consider the possible nuances of approach in so far as non-CCCTB Member States are concerned, due to general EU law obligations. The same goes vis-à-vis anti-abuse rules devised to protect the tax base of the CCCTB group, some of which are analysed below.

5.1.5. The suggested rules on outbound investment (i.e. foreign income received by a member of a CCCTB group as a result of investment in a non-CCCTB member) are considered first.

5.2 Outbound investment – inbound payments

5.2.1. In so far as outbound investment is concerned, the Commission had initially considered two possibilities: either exclude such income completely from the CCCTB, or have it incorporated in the CCCTB and apply the mechanism for consolidation and apportionment.⁴⁷¹

⁴⁷⁰ See Part 1.

⁴⁷¹ See, for example, CCCTB\WP\019\doc\en: 'International Aspects in the CCCTB' (8/12/2005); CCCTB\WP\033\doc\en: 'Report and Discussion on Progress of the Sub-group on International Aspects' (24/5/2006).

5.2.2. In its September 2007 technical discussion document,⁴⁷² the Commission adopted a half-way approach, which distinguished between income from third countries and EU income. The proposed rules were summarised in the following table produced in the technical discussion document.⁴⁷³

EU Resident or EU permanent establishment of non-resident receiving income	From 3rd country	From EU (i.e. another MS)⁴⁷⁴
Income from PE	Exempt, subject to switch over to credit, shared income (+shared credit)	Consolidated
Income from major shareholdings ⁴⁷⁵	Exempt, subject to switch over to credit, shared income (+shared credit)	>75% — consolidated 10–75% — exempt, no switch over
Income from portfolio	Taxable, shared income + shared credit	Consolidated income and credit (WHT if applicable) to be shared
Royalties, patent income, interest (passive income)	Taxable, shared income + shared credit	Consolidated income and credit (WHT if applicable) to be shared

5.2.3. Third country income received from major shareholdings and permanent establishments was to be exempt from the consolidated base, subject to a switch over to the credit method where the corporate tax rate in the source country is low. Portfolio dividends and other passive income were to be taxed with a credit for withholding tax paid. Both the tax and the cost of the credit (up to a limit)⁴⁷⁶ would be shared by the Member States.⁴⁷⁷

5.2.4. In the recent discussion paper on Transactions and Dealings between Group and Entities outside the Group,⁴⁷⁸ the Commission made a few changes and a number of clarifications. Three types of income were to be exempt from taxation; namely, received profit distributions (both portfolio dividends and direct investment), income from permanent establishments situated in third countries and proceeds from the disposal of shares outside the group.⁴⁷⁹ This approach was followed in the draft CCCTB Directive,⁴⁸⁰ the only difference being

⁴⁷² CCCTB57, fn.20.

⁴⁷³ *Ibid*, paragraph 122.

⁴⁷⁴ As will be explained below, it ought to be questioned whether this phrase should encompass CCCTB and non-CCCTB Member States. From the Commission's perspective, the issue does not arise, as there cannot be non-CCCTB Member States.

⁴⁷⁵ More than 10%.

⁴⁷⁶ A mechanism would be required for calculating the limit of the credit to be given by each Member State.

⁴⁷⁷ As for the possible difficulties in sharing this tax credit, see Mitroyanni & Baker, 'The CCCTB and Tax Treaties', Lang et al., fn.18. Also see Mitroyanni (2008), fn.154, Chapter 7.

⁴⁷⁸ CCCTB/RD\003, fn.9.

⁴⁷⁹ *Ibid*, paragraph 5.

⁴⁸⁰ See 'Exempt revenues' provision in Art 11 (c)–(e) of the draft CCCTB Directive. However, there seems to be a slight discrepancy with the preamble to the draft CCCTB Directive, as there, in paragraph 11, it is stated that 'the proceeds from the disposal of shares held in a company outside a group [...] should be exempt'.

that in the main text of the draft CCCTB Directive, all proceeds from the disposal of shares are exempt, not just those outside the group.

5.2.5. Therefore, there is no longer different treatment between income from major shareholdings and income from portfolio. Also there are specific anti-abuse rules relating to these categories of exempt income. All three categories of exempt income are subject to a switch-over clause.⁴⁸¹ It was noted in CCCTB/RD\003 that if such switch-over clause is not foreseen in existing tax treaties with third countries, these treaties would take precedence over conflicting common rules.⁴⁸² The point is not made in the draft CCCTB Directive.

5.2.6. The third category of income (proceeds from the disposal of shares) is also subject to further disallowance where, as a result of the disposal, a taxpayer leaves the group after assets with significant hidden reserves were transferred to it through an intra-group transaction, subject to an escape clause based on commercial justification.⁴⁸³ There is no such justification for the switch-over clause.⁴⁸⁴

5.2.7. CCCTB57 and subsequently CCCTB/RD\003 stipulated that interest, royalties and any other income that did not qualify for exemption would be taxable (shared between the CCCTB group according to the formula) but with a credit for source taxes. This credit would also be shared according to the formula.⁴⁸⁵ The Commission also clarified that relief was limited to ordinary credit – outstanding credits would not be available to carry forward for future years. The only exception would be if an existing tax treaty with a third country provided for more generous relief than ordinary credit.⁴⁸⁶

5.2.8. The new discussion document also clarified that there would be no credit pooling – credits were to be calculated for each source (i.e. Member State/third country) and each type of income separately.⁴⁸⁷ In order to tackle the discrepancy that withholding taxes were levied on gross amounts and the taxation of profits in the CCCTB was based on net amounts, it was permitted, in the absence of proven lower related expenses, to apply a fixed percentage of 2% of the inflow as deemed related expenses.⁴⁸⁸

5.2.9. This approach is largely followed in the draft CCCTB Directive, the only difference being that the draft CCCTB Directive now provides for ‘deduction from the tax liability of the taxpayer’ rather than a credit.⁴⁸⁹ This, arguably, reinforces the fact that there can be no carry forward of the source taxes levied on this type

⁴⁸¹ Under CCCTB/RD\003, only the first two categories were exempt. The switch-over clause is activated if the level of taxation in the third country has not reached at least 40% of the average statutory corporate tax rate applicable in the Member States and there is no special tax regime in the third country that would allow for a substantially lower level of taxation than the general regime. See Art 73 of the draft CCCTB Directive and CCCTB/RD\003, paragraph 8. Also see analysis as a specific anti-abuse rule in Part 6.2 of the report below.

⁴⁸² CCCTB/RD\003, fn.9, paragraph 9.

⁴⁸³ See Art 75 of the draft CCCTB Directive. This is similar to the disallowance of the exempt share disposal in CCCTB/RD\003, fn.9, paragraph 10, though the latter was confined to situation where the intra-group transaction took place within the current or previous tax years. Also see analysis as a specific anti-abuse rule in CCCTB/RD\004, fn.9, paragraphs 22–24, and in Part 3.4 above.

⁴⁸⁴ In CCCTB/RD\003 and CCCTB/RD\004, both the switch-over clause and the disallowance provision were criticised for not containing an escape clause based on commercial justification and for not being aligned with other anti-abuse rules in the Commission’s paper on anti-abuse rules. See, for example, the position paper of Business Europe Task Force, dated 20/11/2010.

⁴⁸⁵ CCCTB/RD\003, paragraph 11.

⁴⁸⁶ *Ibid*, paragraph 12.

⁴⁸⁷ *Ibid*, paragraph 13. It has been argued that this makes the system more administratively burdensome. See Business Europe Task Force position paper.

⁴⁸⁸ CCCTB/RD\003, paragraph 14.

⁴⁸⁹ See Art 76 of the draft CCCTB Directive.

of income – something that has already been the subject of criticism when the discussion documents were released.⁴⁹⁰ However, the use of different terms (deduction/credit) might just be random, as the preamble to the draft CCCTB Directive refers to credit being given in such circumstances.⁴⁹¹

5.2.10. In discussing the tax treatment of EU income, in CCCTB57 and CCCTB/RD\003 the Commission did not distinguish between CCCTB and non-CCCTB Member States. Nor does it do so under the draft CCCTB Directive. This is to an extent understandable, given that the Commission does not recognise the possibility of Member States opting out. What if some Member States *did* opt out? In other words, what if there were non-CCCTB Member States? What rules would apply to investment into and out of the CCCTB zone but within the EU?

5.2.11. In footnote 37 to CCCTB57, the Commission stated that '[the CCCTB] Directive would override conflicting provisions in any agreement concluded between Member States'.⁴⁹² This reflected the Commission's view that EU law overrides bilateral treaties between Member States in the same way as it overrides national law generally within the Union. This was reiterated in the recent discussion document⁴⁹³ and in the draft CCCTB Directive, which states that '[t]he provisions of this Directive shall apply notwithstanding any provision to the contrary in any agreement concluded between Member States'.⁴⁹⁴

5.2.12. On the one hand, it might be argued that the relevant provisions of the CCCTB Directive would not replace the provisions of agreements (including tax treaties) between Member States opting out of the CCCTB and those opting in, so that all EU-sourced income (non-CCCTB and CCCTB) is taxed in the same way. On the other hand, it might be argued that even if the CCCTB Directive is not adopted by all Member States but only by some under enhanced co-operation, non-CCCTB Member States would still be under a general EU law obligation to respect the Directive and to adapt to its provisions.

5.2.13. As mentioned above,⁴⁹⁵ although non-participating Member States are not bound by the CCCTB under enhanced co-operation between participating Member States, they are under a duty not to impede its implementation. The enabling provisions of the Treaties do not delimit the extent of this duty of non-impediment. Although the scope of the obligations of the non-participating Member States is currently unclear, the duty of non-impediment buttressed by the general duty of EU loyalty may prove to be far greater than what was initially anticipated.

5.2.14. Due to the Commission's strategy not to anticipate any abstainers from the CCCTB proposal, no firm answers can be given to these questions. Obviously, this issue affects the interpretation of the provisions of the draft CCCTB Directive. For example, it is thought that EU income received from (EU) permanent establishments would *always* be consolidated. What about income from

⁴⁹⁰ The general unavailability of credit carry forward had been criticised by Business Europe Task Force in its position paper.

⁴⁹¹ See paragraph 12, which reads as follows: 'Income consisting in interest and royalty payments should be taxable, with credit for withholding tax paid on such payments. Contrary to the case of dividends, there is no difficulty in computing such a credit.'

⁴⁹² CCCTB57, fn.20.

⁴⁹³ See CCCTB/RD\003, paragraph 3, which stated that '[i]n conformity with the principle of supremacy of EU law, the common rules will generally take precedence over rights and obligations arising from (bilateral or multilateral) agreements between Member States'.

⁴⁹⁴ See Art 8 of the draft CCCTB Directive.

⁴⁹⁵ See paragraph 2.1.155 of this report.

permanent establishments in non-CCCTB Member States, for example from UK permanent establishments?⁴⁹⁶

5.2.15. It is unlikely that the profits of the UK permanent establishments could be so consolidated if the head office is established in the CCCTB area. It is more likely that they will be exempt as in the case of third country permanent establishments. If they were consolidated, then UK tax treaties with CCCTB jurisdictions, which follow a separate entity approach in attributing profits to permanent establishments, may be overridden. If the UK exempts income of a UK permanent establishment when the head office is located within the CCCTB area (whether by domestic law, or under a tax treaty, or as a result of a special provision to facilitate the functioning of the CCCTB), then consolidation of the profits of the permanent establishments would not be an issue.

5.2.16. Certainly, if the Commission were to acknowledge the possibility of non-CCCTB Member States, then it ought to draw its own distinct rules (or reach a compromise) vis-à-vis such income from non-CCCTB Member States.

5.2.17. Under the current Commission proposals, received profit distributions are exempt and other passive income is by default consolidated.⁴⁹⁷ Any withholding tax imposed⁴⁹⁸ at source will be relieved by deduction⁴⁹⁹ (formerly by credit) within the consolidated group. What if portfolio dividends and other passive income are derived from non-CCCTB Member States? Arguably, these items would, unless exempt, either be consolidated or separately taxable by the recipient CCCTB Member State. Given that the Commission does not acknowledge the existence of non-CCCTB Member States, let alone income from such Member States, one cannot say with certainty how it will be taxed (i.e. similar to CCCTB income or third country income).

5.2.18. General principles set out in the case law of the Court of Justice will, arguably, still be relevant. Therefore, shareholders in a CCCTB group receiving inbound dividends would have to be treated the same way as shareholders receiving domestic dividends if they are in an objectively comparable situation, unless different treatment is justified. This could mean that a CCCTB Member State providing reliefs for domestic dividends received by resident shareholders would have to provide the same relief at least for EU-sourced and, by analogy, CCCTB-sourced dividends.⁵⁰⁰ Non-EU sourced dividends may not warrant the same treatment with domestic dividends, for example, if there are no provisions for exchange of information between the Member State of the recipient and the country of the distributing entity.⁵⁰¹

5.2.19. The same principles would apply to non-CCCTB Member States. Even if the UK opts out of the CCCTB, there is no reason why the general principles of the Court's jurisprudence will not still apply. If anything, the duty of non-impediment of the enhanced co-operation procedure buttressed by the general duty of EU

⁴⁹⁶ Under UK tax treaties, profits of foreign permanent establishments of UK companies are consolidated and taxed on a worldwide basis. As the UK consolidates the profits of foreign permanent establishments and taxes on a worldwide basis it might have to reconsider this approach in the case of permanent establishments established in the CCCTB area. But this would be a domestic UK matter.

⁴⁹⁷ This can be inferred from Arts 11 and 57(1).

⁴⁹⁸ As matters currently stand, withholding tax between consolidated entities is not prohibited.

⁴⁹⁹ See Art 76.

⁵⁰⁰ See, for example, Case C-35/98 *Verkooijen* [2000] ECR I-4071; Case C-315/02 *Lenz* [2004] ECR I-7063; Case C-319/02 *Petri Manninen* [2004] ECR I-7477; Case C-446/04 *FII Group Litigation* [2006] ECR I-11753; Joined Cases C-436/08 *Haribo* and Case C-437/08 *Österreichische Salinen* etc.

⁵⁰¹ Case C-101/05 *Skatterverket v. A* [2007] ECR I-11531; Case C-72/09 *Rimbaud*.

loyalty will make it an imperative for the non-CCCTB Member State to follow the general principles under the Court's case law. Arguably, therefore, the UK may have to treat portfolio dividends and passive income from a CCCTB and a non-CCCTB Member State the same way, unless there is a significant ground justifying non-comparability.

5.2.20. Compliance with this may no longer be troublesome. As passive income other than profit distributions is taxable under the CCCTB, then there will not be much difference of treatment if the UK imposes inbound taxes on such income. The same argument applies to portfolio distributions, which are exempt under the latest discussion document mentioned above.⁵⁰² Following the new foreign profits tax regime enacted in Finance Act 2009, there is now an exemption regime for foreign dividends.⁵⁰³ Broadly, under the new regime, all dividends and other distributions of resident and non-resident companies are charged to corporation tax, unless there is an exempt distribution.⁵⁰⁴ A distribution in respect of portfolio holdings is an exempt distribution.⁵⁰⁵ There are some anti-avoidance rules in the new legislation⁵⁰⁶ for schemes involving manipulation of the categories of exempt distributions.⁵⁰⁷ If a distribution is caught by these rules and becomes taxable, leading to a discriminatory treatment of domestic and inbound dividends, then it is very likely the anti-avoidance rules would constitute an imperative ground in the public interest. Therefore, the new legislation is likely to cater for the nuances of the CCCTB if applied in a context in which there are participating and non-participating Member States.

5.3 Inbound investment – outbound payments

5.3.1. The treatment of inbound investment was less settled in the Commission's initial proposals. Here, it seemed that in so far as inbound investment and outgoing payments were concerned, the Commission made a much broader distinction. It treated all payments out of the CCCTB group as outbound payments, regardless of whether the payment was made to a Member State or a third country recipient of the income.

5.3.2. What appeared to be important to the Commission was the fact that the payment was made to a *non-taxpayer*, i.e. a company that was not part of the CCCTB group, whether because it did not satisfy the group/consolidation threshold⁵⁰⁸ (even if resident in the same Member State) or in a third country (or,

⁵⁰² CCCTB/RD\003, fn.9, paragraph 5.

⁵⁰³ See, generally, Neil Edwards, 'Taxation of Foreign Profits 2009–2010', edited by Philip Baker, Peter Cussons, John Fairley, Ian Sandles, Rupert Shiers, Richard Sumner, James MacLachlan (LexisNexis Butterworth, 2009).

⁵⁰⁴ Section 931A CTA 2009.

⁵⁰⁵ Section 931G CTA 2009. Overall, there are five classes of exempt distributions set out in sections 931E–931I CTA 2009. Apart from distributions in respect of portfolio holdings, there are also distributions from controlled companies (section 931E CTA 2009), distributions in respect of non-redeemable ordinary shares (section 931F CTA 2009), dividends derived from transactions not designed to reduce tax (section 931H CTA 2009) and dividends in respect of shares accounted for as liabilities (section 931I CTA 2009). The distributions cannot be of a capital nature (section 931A(2) CTA 2009).

⁵⁰⁶ See sections 931J–931Q CTA 2009.

⁵⁰⁷ For example, if there is a scheme involving manipulation of controlled company rules (section 931I CTA 2009), a scheme involving quasi-preference or quasi-redeemable shares (section 931K CTA 2009), a scheme involving manipulation of portfolio holdings rule (section 931L CTA 2009), a scheme in the nature of loan relationships (section 931M CTA 2009), a scheme involving distributions for which deductions are given (section 931N CTA 2009), a scheme involving payments for distributions (section 931O CTA 2009), a scheme involving payments not on arm's length terms (section 931P CTA 2009) and a scheme involving diversion of trade income (section 931Q CTA 2009). See Edwards, fn.503, Chapter 1.

⁵⁰⁸ See analysis above in Part 2.1.

arguably, by analogy, in a non-CCCTB Member State). This can be delineated from paragraph 18 of CCCTB57:

5.3.3. 'Withholding taxes and other source taxation on payments made by a taxpayer⁵⁰⁹ to a non-taxpayer, *whether EU resident or not*,⁵¹⁰ would continue to be governed by domestic and tax treaty arrangements. However, it would be important to work as soon as possible towards common arrangements in order to prevent distortions in patterns of investment.'⁵¹¹

5.3.4. The Commission, in its recent discussion document on Transactions and Dealings between the Group and Entities outside the Group⁵¹² proceeded on the same basis. So does the draft CCCTB Directive, which provides that '[i]nterest and royalties paid by a taxpayer to a recipient outside the group may be subject to a withholding tax in the Member State of the taxpayer according to the applicable rules of national law and any applicable double tax convention'.⁵¹³ This withholding tax is to be shared among the Member States according to the formula applicable in the tax year in which the tax is charged.⁵¹⁴

5.3.5. This stance is understandable given the apparent tactic of the Commission not to anticipate abstainers from the CCCTB – for the time being. However, the possibility exists that means that, in reality, it is unlikely that all outgoing payments (i.e. to EU and non-EU recipients) would be treated the same way. Therefore, in the following analysis, whenever relevant, the likelihood of a different approach for non-CCCTB Member States as a result of the nuances of EU law (and the Directives) is considered. This is especially important to the UK.

5.3.6. A non-taxpayer would be interested to see how profits of its consolidated (EU) permanent establishment are allocated or how outgoing payments from the consolidated entity are taxed. As mentioned, under CCCTB57 and subsequently the draft CCCTB Directive, the profits of a CCCTB permanent establishment will be subject to the consolidation rules.⁵¹⁵

5.3.7. The problem with this approach is that the standard (tax treaty) practice is for business profits to be allocated to a permanent establishment on an arm's length basis. Thus, if the non-taxpayer head office is in a non-CCCTB country (whether within the EU or in a third country) and income of a permanent establishment in a CCCTB country is consolidated with the CCCTB allocating higher profits to the permanent establishment after formulary apportionment, then the country of the non-taxpayer head office may find such practice to be contrary to the underlying tax treaty and require recalculation of the permanent establishment's profits according to the arm's length principle.

5.3.8. This may be especially problematic if the state of residence of the head office is a credit country, such as the UK, and has to give relief by credit.⁵¹⁶ However, as already mentioned, the UK is moving to a more territorial basis for

⁵⁰⁹ A 'taxpayer' is used in the discussion document to refer to companies that have opted for the CCCTB. CCCTB57, fn.20, paragraph 13.

⁵¹⁰ Emphasis added.

⁵¹¹ *Ibid*, paragraph 18.

⁵¹² CCCTB/RD\003.

⁵¹³ Art 77.

⁵¹⁴ *Ibid*.

⁵¹⁵ Art 57(1).

⁵¹⁶ See Mitroyanni (2008), fn.154, p.166.

taxing the profits of foreign permanent establishments of UK companies, as originally announced in the June 2010 Budget.

5.3.9. It was initially thought that the objection would be the same, regardless of whether the head office is in a non-CCCTB Member State or in a third country, unless EU law can be construed as imposing a special duty of loyalty on non-CCCTB Member States and an obligation to respect CCCTB principles and accommodate their application, to the detriment of their tax treaty rights.

5.3.10. In an earlier report,⁵¹⁷ the Commission considered the possibility of devising common rules for the allocation of profits to the EU permanent establishment of a non-resident taxpayer (without distinguishing between non-resident taxpayers in the EU or outside of the EU). This required an agreement on a common approach to the analysis of risks, functions and activities performed by the permanent establishment and the allocation of assets, liabilities, income and expenses between the permanent establishment and the head office. Whilst recognising the importance of working towards common arrangements, the Commission's approach in CCCTB57 was one of deference to the OECD Model and existing tax treaties with third countries.

5.3.11. This approach has now been to an extent clarified, and for third countries solidified, following the recent discussion document CCCTB/RD\003.⁵¹⁸ In this document, the Commission made a distinction between rights and obligations arising from agreements between Member States and rights and obligations arising from agreements between Member States and third countries concluded before the CCCTB Directive entered into force. In the former case, the CCCTB rules would take precedence. In the latter case, agreements incorporating rights and obligations contrary to the Directive would not be affected.⁵¹⁹

5.3.12. In CCCTB/RD\003, the Commission gave as an example the situation whereby a Member State agrees under a tax treaty with a third country to allocate profits of a CCCTB permanent establishment according to the arm's length principle. Given that the tax treaty was concluded prior to the CCCTB Directive, according to the Commission, the arm's length rule would override formulary apportioned, *as regards the obligation of the third country to give relief for double taxation*.⁵²⁰ Therefore, in practical terms, 'a third country which relieves double taxation by the credit method will have to give a credit only up to the level of an "arm's length" allocation of revenues to the PE'.⁵²¹ The Commission did not deal with the situation where the arm's length amount was lower than the amount apportioned under the CCCTB formula. The European Business Initiative on Taxation had called for the Commission to reconsider its position to ensure that credit is given for the actual CCCTB tax paid.⁵²²

5.3.13. Although the rights and obligations arising from agreements between Member States and third countries are not raised in the draft CCCTB Directive, the above treatment may be inferred by the fact that the only provision expressly allowing a treaty override is limited to agreements concluded between Member

⁵¹⁷ CCCTB\WP\033\doc\en: 'Report and Discussion on Progress of the Sub-group on International Aspects' (24/5/2006).

⁵¹⁸ CCCTB/RD\003, fn.9.

⁵¹⁹ *Ibid*, paragraph 3.

⁵²⁰ *Ibid*, paragraph 4.

⁵²¹ *Ibid*.

⁵²² EBIT, Contribution to the European Commission Workshop on the CCCTB, 20 October 2010, p.5

States.⁵²³ Furthermore, there is no reason why the Commission's view cannot be taken into account in the interpretation of the draft CCCTB Directive, even though the discussion documents are not legally binding *per se*.⁵²⁴

5.3.14. Therefore, it appears to be suggested that in cases of a permanent establishment within a CCCTB group, where there is a conflict between the arm's length principle and formulary apportionment, only third countries can fall back on the underlying tax treaty, to the extent of *their* obligations and only if the tax treaty preceded the CCCTB Directive. In all other circumstances, i.e. where the head office of the permanent establishment is a non-CCCTB Member State, the CCCTB rules will take precedence.

5.3.15. One general way of avoiding tax treaty disputes as a result of conflicting methods of allocation of income of permanent establishments is for CCCTB countries to renegotiate their tax treaties with non-CCCTB countries (both EU and non-EU) so as to encompass alternative allocation methods.⁵²⁵ For example, the state of residence of the head office could exempt income of a permanent establishment arising in a CCCTB jurisdiction (whether by domestic law, or under a tax treaty, or as a result of a special provision to facilitate the functioning of the CCCTB). In such cases, consolidation of the profits of the CCCTB permanent establishment and, subsequently, formulary apportionment would not raise any problems.

5.3.16. Whilst this may have now become imperative as regards non-CCCTB Member States given that a general obligation to respect the CCCTB arrangement '[i]n conformity with the principle of supremacy of EU law'⁵²⁶ is explicitly recognised (arguably a much stronger obligation compared to that derived from enhanced co-operation), the Commission seems to understand that it would be a truly daunting task *vis-à-vis* third countries – hence the grandfathering clause for existing tax treaties. It would also seem counter-intuitive to the OECD's recent adoption of separate entity accounting methods.⁵²⁷ In any case, all non-CCCTB jurisdictions,⁵²⁸ whether in the EU or outside of the EU, may have to work out ways of ensuring that the possibly simultaneous application of apportionment and allocation methods of attribution for income of a permanent establishment does not lead to double taxation, or double non-taxation.⁵²⁹

⁵²³ Art 8 of the draft CCCTB Directive.

⁵²⁴ See, for example, the disclaimer in CCCTB/RD\003: 'This paper has been prepared to facilitate discussion on possible rules to be included in a possible proposal for a CCCTB Directive. For convenience, use is often made of phrases such as "the rule will apply", "interest will be deductible where..." etc. It should however be noted that such wording is meant to represent only the latest technical expert views which may be subject to change and in no way pre-judges the contents of a possible future Commission proposal.'

⁵²⁵ CCCTB\WP\026\doc\en: 'The Territorial Scope of the CCCTB' (9/10/2006), paragraphs 33–34.

⁵²⁶ CCCTB/RD\003, paragraph 3.

⁵²⁷ The 'functionally separate entity' approach has been preferred for the purposes of allocating profits to a permanent establishment under Article 7 OECD Model. See 2010 version of OECD Model and OECD, 2010 Report on the Attribution of Profits to Permanent Establishments.

⁵²⁸ Although a non-taxpayer in a CCCTB country who receives 'outgoing' income (outgoing from a taxpayer/CCCTB group) may in fact face similar problems, the CCCTB Directive should presumably prevail over conflicting domestic or tax treaty obligations.

⁵²⁹ Mitroyanni has suggested two alternatives as medium term solutions in the context of permanent establishments owned by companies in third countries. First, the third country that subjects permanent establishment profits to residence taxation could be given the opportunity to limit its credit to the lower of the permanent establishment's tax liability computed under formulary apportionment and at arm's length. Second, the CCCTB jurisdiction where the permanent establishment is established as a state of source would tax the narrower of the tax base computed under formulary apportionment and at arm's length: Mitroyanni (2008), fn.154, pp.165–166. Following CCCTB/RD\003, these solutions may no longer be relevant to third countries but may be relevant to non-CCCTB Member States.

5.3.17. In so far as payments (e.g. dividends, interest, royalties) are made by a taxpayer company to a (non-resident)⁵³⁰ non-taxpayer, there was initially some debate as to whether any withholding tax levied on this income by the Member State of the payer should be subject to consolidation or whether it should stay outside of the common tax base. In other words, it was questionable whether the (source country) right to impose a withholding tax was to be assigned to the whole of the CCCTB group or would remain with the Member State of the payer.

5.3.18. In an earlier report,⁵³¹ the Commission put forward the view that if the amount paid was going to be deducted (as an expense) from the common base and, as a corollary, was to reduce the common tax base, then the withholding tax received by the Member State of the payer had to be shared out according to an agreed mechanism. Arguably, this treatment was unlikely to affect the recipient company, unless for some reason, the recipient was entitled to refund of the withholding tax, in which case, administrative difficulties might have ensued in recovering the apportioned withholding tax.⁵³²

5.3.19. In CCCTB57, the Commission withdrew this suggestion and deferred more to existing domestic and tax treaty arrangements. It accepted that withholding taxes and other source taxation on outgoing payments would continue to be governed by such existing arrangements.⁵³³ At the same time, however, the Commission urged Member States to work 'towards common arrangements in order to prevent distortions in patterns of investment'.⁵³⁴

5.3.20. This stance was reversed in CCCTB/RD\003 and the draft CCCTB Directive. There is now a distinction between withholding taxes on outbound interest and royalty payments and withholding taxes on dividend distributions. For interest and royalty payments, proceeds from applying withholding taxes are shared out between the Member States of the group members using the formula.⁵³⁵ By contrast, there is no share out of withholding taxes on dividends between group members. These will continue to be dealt with at national level.⁵³⁶

5.3.21. The rationale for this different treatment is traceable to earlier reports. As interest and royalty payments are generally tax deductible at source, the relevant cost will already have been shared among group members – so should the revenue from withholding tax. This is not the case for dividends, which are after-tax payments and have normally led to no shared deduction of costs. Therefore, there should be no sharing of the revenue.⁵³⁷

5.3.22. This is an understandable and welcome position. It should be kept in mind that payments of dividends, interest and royalties made from a taxpayer subsidiary to a non-taxpayer EU parent in a non-CCCTB Member State may still

⁵³⁰ If the non-taxpayer is resident, then, arguably, there would be no withholding tax unless the country imposes withholding taxes on domestic and outbound payments. If the latter is the case, then, arguably, there is no difference between resident and non-resident non-taxpayers.

⁵³¹ CCCTB\WP\049\doc\en\rev: 'Report and Discussion on Progress of the Sub-group on International Aspects: An overview of the main issues that emerged at the third meeting of the subgroup on International aspects' (SG 4)(23/11/2006), paragraph 9.

⁵³² Presumably, only the withholding tax net of any refund would have been shared: the issue would have been for the Member State of the payer and not the recipient.

⁵³³ CCCTB57, fn.20, paragraph 18.

⁵³⁴ *Ibid.*

⁵³⁵ CCCTB/RD\003, fn.9, paragraph 15 and Art 77.

⁵³⁶ Although this is expressly stated in CCCTB/RD\003, the point is not made in Art 77, which merely deals with the treatment of withholding taxes on outbound interest and royalty payments. However, the distinction is made clear and the reasons behind it explained in paragraph 18 of the preamble.

⁵³⁷ See CCCTB/RD\003, fn.9, paragraph 15 and paragraph 19 of the preamble.

be exempt from withholding tax, if the threshold requirements of the Parent-Subsidiary⁵³⁸ and Interest and Royalty Directives⁵³⁹ are met. In this regard, therefore, some outgoing payments (namely those from major shareholdings) may be treated differently depending on whether the recipient is a non-taxpayer in the EU or in a third country. The former would enjoy the protection of these Directives, in addition to any protection under tax treaties.

5.3.23. Notwithstanding this, non-taxpayers in EU Member States receiving CCCTB income would have to take note of the various carve-outs of these Directives and how they are applied by the Member State of the payer (e.g. anti-abuse provisions, minimum holding period requirements etc.). Since the CCCTB does not, so far, provide for a co-ordinated application of these carve-outs when CCCTB Member States make payments to major shareholders, then, arguably, CCCTB Member States may continue to apply these carve-outs as they did before.⁵⁴⁰

5.3.24. As for outgoing portfolio dividends and passive income, tax treaties may offer some protection since the Directives do not cover such payments. The principles set out in the case law of the Court of Justice may also offer significant protection when there is discrimination and unequal treatment. Under general case law, the source state has to ensure equal tax treatment of resident and non-resident recipients of dividends, if they are in a comparable situation. Resident and non-resident shareholders are in a comparable situation if they are both subject to source state taxes.⁵⁴¹ In some cases, restrictions affecting EEA or third country recipients of dividends are justified when such restrictions affecting EU recipients are not. This is usually the case when the country of the recipient does not have provisions in place for exchange of information.⁵⁴²

5.3.25. The above rules should be considered also in the context of the CCCTB anti-abuse rules. These are examined below.

⁵³⁸ Directive 90/435/EEC of 23 July 1990 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries in Different Member States. This Directive was amended by Council Directive 2003/123/EC of 22 December 2003.

⁵³⁹ Council Directive 2003/49/EC of 3 June 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between Associated Companies of Different Member States.

⁵⁴⁰ Of course, case law on these carve-outs is to be taken into account. See, for example, Case C-58/01 *Océ van der Grinten NV* [2003] ECR I-9809 and Case C-283/94 *Denkavit International BV* [1996] ECR I-5063.

⁵⁴¹ Case C-374/04 *ACT IV Group Litigation*, fn.339; Case C-170/05 *Denkavit* [2006] ECR I-11949; Case C-379/05 *Amurta* [2007] ECR I-9569; Case C-540/07 *Commission v. Italy* [2009] ECR I-0000; Case C-487/08 *Commission v. Spain* etc.

⁵⁴² As regards EEA countries, see Case C-540/07 *Commission v. Italy* [2009] ECR I-0000 and Case C-72/09 *Rimbaud*. As regards third countries see Case C-101/05 *Skatteverket v A* and Case C-201/05 *CFC GLO* [2008] ECR I-02875.

6. Anti-abuse rules

6.1 Generally

6.1.1. Prior to the release of a discussion paper on the CCCTB anti-abuse rules in April 2008, the Commission had not really given any detailed suggestions on anti-abuse rules in the context of the CCCTB. Neither had it given a view as to whether any anti-abuse rules would apply in the same way to non-CCCTB Member States and third countries – for obvious reasons. What it had said in a number of earlier reports is that it was desirable to create common rules when the common *consolidated* tax base was directly affected.

6.1.2. Controlled foreign companies, thin capitalisation and fat capitalisation were mentioned in CCCTB57 as areas in which the CCCTB may need to provide special rules.⁵⁴³ However, no concrete suggestions were made. Rather, comments were invited.

6.1.3. In April 2008, the Commission released CCCTB65, a discussion paper focusing on anti-abuse rules for the CCCTB.⁵⁴⁴ In this paper, the Commission referred to its previous (non-CCCTB related) Communication on ‘The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries’ (henceforth, Communication on anti-abuse measures).⁵⁴⁵ According to the Commission, the latter Communication provided ‘a useful framework for the concrete rules of the CCCTB but obviously the CCCTB needs to be more specific and detailed than the Communication’.⁵⁴⁶

6.1.4. Within the CCCTB, there could be general or specific anti-abuse provisions; or both. If a general anti-abuse rule was established, then the ‘taxpayer should always be able to refute this by producing evidence of a commercial justification’.⁵⁴⁷ Although such rule would provide Member States with a flexible tool to combat abusive practices, it may be a difficult provision to apply and be interpreted differently within Member States, thus introducing uncertainty.⁵⁴⁸

6.1.5. In CCCTB65, the Commission expressed its preference in favour of a general anti-abuse rule underpinned by specific anti-abuse provisions. Such combination would ‘provide tax administrations with easily [ascertainable] and straight forward specific rules to combat specific and well known cases of abuse and a general rule could be applied to combat possible abuse that was not foreseen when designing the common rules’.⁵⁴⁹

6.1.6. The Commission went on to analyse a number of specific anti-abuse provisions. *Inter alia*, it looked at thin capitalisation rules and more general rules restricting interest deductibility, CFC rules and switch-over clauses from

⁵⁴³ For CFCs, see CCCTB57, fn.20, paragraph 127–129; for fat capitalisation, see paragraph 130. Passing reference is made to thin capitalisation in fn.41.

⁵⁴⁴ CCCTB65, fn.361.

⁵⁴⁵ COM (2007) 785.

⁵⁴⁶ CCCTB65, fn.361, paragraph 2.

⁵⁴⁷ *Ibid*, paragraph 6.

⁵⁴⁸ *Ibid*, paragraph 8.

⁵⁴⁹ *Ibid*, paragraph 9.

exemption to credit, as well as rules to avoid possible double deductions (double dips) in a 'sandwich' situation. The Commission also examined rules to re-characterise the sale of shares as *sale of assets* to avoid the abuse of the consolidation rules in connection with the participation exemption. Furthermore, the Commission examined possible rules to avoid the manipulation of the factors in formulary apportionment.

6.1.7. Most of these issues were revisited and refined in the Commission's recent discussion document entitled *Anti-Abuse Rules in the CCCTB*.⁵⁵⁰ In this document, the anti-abuse 'shield' of the CCCTB was effectively structured through rules at two levels: namely, through a General Anti-Abuse Rule (GAAR) and through specific anti-abuse rules.

6.1.8. The GAAR was to be triggered when a transaction or a series of transactions was carried out for the sole purpose of avoiding taxation. Practices without economic substance were targeted (in accordance with the concept of purely artificial arrangements of the Court of Justice) and artificial steps ignored.⁵⁵¹ There was an escape clause if the taxpayer showed evidence of a commercial justification for its activity, even if the scheme was in essence designed to mitigate tax.⁵⁵² The GAAR would only be relevant if the potentially abusive practices were not caught by any of the other specific anti-abuse rules.⁵⁵³ The specific rules⁵⁵⁴ had the function of protecting the consolidated tax base from erosion in relations between the group and the outside world, or for intra-group transactions.⁵⁵⁵

6.1.9. Furthermore, under CCCTB/RD\04, some crucial anti-abuse rules were only applicable vis-à-vis third countries companies (thin capitalisation rule, switch-over clause and CFC rule).⁵⁵⁶ The document did not include any discussion on how these rules were to apply vis-à-vis companies in Member State that opted out of the CCCTB. Nor was there any discussion on the potential overlap between domestic and CCCTB anti-abuse rules.

6.1.10. The approach in CCCTB/RD\04 has been largely followed in the draft CCCTB Directive, though there are some subtle differences. The GAAR, set out in Art 80,⁵⁵⁷ is similarly structured to that in CCCTB/RD\004. However, in the draft CCCTB Directive there does not appear to be an express hierarchy between the GAAR and the specific anti-abuse rules. In other words, it is not made clear in the main text of the draft CCCTB Directive whether the GAAR would only apply if the other rules do not. Neither is it made clear in the preamble.⁵⁵⁸ Therefore, a tax

⁵⁵⁰ CCCTB/RD\004, fn.9

⁵⁵¹ *Ibid*, paragraph 6.

⁵⁵² *Ibid*, paragraph 7.

⁵⁵³ *Ibid*, paragraph 9.

⁵⁵⁴ The rules listed were the following: (i) disallowance of third-country source interest deduction; (ii) switch-over from a tax exemption of foreign income to relief by credit; (iii) controlled foreign company legislation; (iv) disallowance of the participation exemption in share disposals; (v) rules to tackle double deductions in 'sandwich cases'; (vi) rules to avoid a manipulation of the asset factor.

⁵⁵⁵ *Ibid*, paragraph 5.

⁵⁵⁶ This is understandable given that the consultations submitted to the Commission prior to the December 2007 discussion documents revealed that the business community was less inclined to have CFC rules applied within the EU for the purposes of the CCCTB.

⁵⁵⁷ This Article provides that artificial transactions carried out for the sole purpose of avoiding taxation will be ignored for the purposes of calculating the tax base. This rule does not apply to genuine commercial activities where the taxpayer is able to choose between two or more possible transactions, which have the same commercial result but produce different taxable amounts.

⁵⁵⁸ See paragraph 20 of the preamble which states that '[t]he system should include a general anti-abuse rule, supplemented by measures designed to curb specific types of abusive practices'.

authority may be tempted to use the GAAR, which is more general and vague, rather than specific anti-abuse rules.

6.1.11. This is exacerbated by the fact that the specific anti-abuse rules, as set out in CCCTB/RD\004, are scattered in the draft CCCTB Directive in such a way that it is not always immediately apparent that they constitute anti-abuse rules. In fact, Chapter XIV of the draft CCCTB Directive, entitled Anti-Abuse Rules, contains only two specific anti-abuse rules (apart from the GAAR); namely, disallowance of interest deductions⁵⁵⁹ and controlled foreign companies.⁵⁶⁰ Again, it is not clear whether this is an intentional deviation from CCCTB/RD\004, or whether it is a deviation at all. Nevertheless, it may help tilt the balance in favour of tax authorities more frequently than not.

6.1.12. Overall, the need for a GAAR remains perplexing. So does its scope and its overlap with other anti-abuse rules. One thing to note is that under the draft CCCTB Directive the application of the GAAR is not restricted to third country entities. This could have important repercussions, not only for CCCTB companies but also for non-CCCTB EU companies. It could prove to be a means to bridge some of the differences between domestic and CCCTB anti-abuse rules, as well as fill the gaps in the design of CCCTB anti-abuse rules vis-à-vis non-CCCTB EU companies.

6.1.13. Some of these issues are examined in greater detail below.

6.2 Controlled foreign companies

6.2.1. It was the initial assumption that CCCTB Member States would develop and adopt common CFC rules within the CCCTB. This was a matter of concern to non-CCCTB Member States and third countries, especially if they had low-taxed regimes.

6.2.2. In CCCTB57, the Commission admitted that, due to the proposed exemption on outbound investment, measures would be required to protect the tax base. Two possibilities were identified, i.e. first, a switch-over to credit if exemption was not justified because of the low local taxation on the foreign profits and, second, a common CFC regime.⁵⁶¹

6.2.3. In so far as a switch-over clause was concerned, in CCCTB57 the Commission gave the following example: exemption could be conditional on profits from third countries being subject to not less than 40% of the average statutory corporate income tax rate applicable in their Member State and not being subject to a special regime resulting in a substantially lower level of taxation.⁵⁶²

6.2.4. In so far as a common CFC regime was concerned, the Commission invited comments on '(i) what types of income such a regime should target; (ii) what ownership threshold should apply; (iii) whether it should apply only in the case of undistributed profits in low rate jurisdictions or should apply generally to certain income types, whether distributed or not; (iv) whether the same or

⁵⁵⁹ Art 81 of the draft CCCTB Directive.

⁵⁶⁰ Art 82.

⁵⁶¹ CCCTB57, fn.20, paragraph 127.

⁵⁶² *Ibid*, paragraph 128.

different arrangements should apply to domestic, non-consolidated EU and third country companies; and (v) whether such a regime would be seen as an alternative or an adjunct to a switch-over mechanism.⁵⁶³

6.2.5. In the December 2007 (annotated) technical discussion document,⁵⁶⁴ the Commission disclosed some of the comments made by Member States on this issue. The Commission noted that, apart from some divergences,⁵⁶⁵ most of the Member States agreed that any CFC legislation should primarily cover passive income and should not hinder real economic activities.⁵⁶⁶ Consultations from the business sector also showed lack of 'appetite' for CFC rules.⁵⁶⁷

6.2.6. Under CCCTB/RD\004, the switch-over clause was preserved as an exception to the general rule of exempting inbound profit distributions, proceeds from share disposals and income earned from third-country located permanent establishments.⁵⁶⁸ These otherwise exempt inflows were made taxable and credit was given for tax already paid at source. The aim was to discourage the inflow of revenues through low-tax third countries.⁵⁶⁹

6.2.7. For the purposes of this provision, according to the Commission, a low-tax third country was one that operated under its general tax regime, a statutory corporate tax rate lower than 40% of the average statutory corporate tax rate in the Member States or a special regime allowing for substantially lower tax than its general regime.⁵⁷⁰

6.2.8. The switch-over clause, as set out in Art 73 of the draft CCCTB Directive, adopts the Commission's wording in CCCTB/RD\004. The only difference is that the provision is listed in Chapter XII, entitled Dealings between Group and Other Entities, rather than within the Anti-Abuse Rules chapter. Also, Art 73 further adds that the average statutory corporate tax rate applicable in the Member States will be published by the Commission annually and will be calculated as an arithmetic average.

6.2.9. It would seem that the current drafting of the switch-over clause continues to perpetuate the confusion as to whether the switch-over clause can be applicable to non-CCCTB Member States. It is also unclear whether in finding the average statutory corporate tax rate in the EU, only participating Member States will be taken into account. Moreover, the switch-over clause does not have

⁵⁶³ *Ibid*, paragraph 129.

⁵⁶⁴ CCCTB/WP057annotated, fn.4.

⁵⁶⁵ *Ibid*, page 32. One Member State suggested that CFC rules should also apply to mobile activities. Another Member State suggested that CFC rules should apply when more than one-third of an entity's income was financial.

⁵⁶⁶ On the relevant participation to be covered, one Member State recommended making use of a 25% threshold and another a 50% threshold (whether of voting rights or capital or any rights). On the geographic scope of a CFC regime, several Member States wanted CFC measures to apply to any entities not included in the CCCTB group and this would include EU and third country entities. In addition, one Member State stressed that CFC rules should be complementary to switch-over clauses and should not be applied as an alternative. *Ibid*.

⁵⁶⁷ For example, Business Europe Task Force considered that there was no need for CFC rules as the switch-over mechanism sufficed. However, '[s]uch a clause would only apply vis-à-vis third countries and never vis-à-vis EU States (even for those which would not participate in the CCCTB)': CCCTB/WP057annotated, fn.4, p.32. EUROCHAMBRES even proposed the gradual abolition of CFC regimes. Specifically, CFC rules 'try to prevent resident companies from avoiding domestic tax by diverting income to subsidiaries in countries with a significantly lower level of taxation and thus tax abuse. There is a need to avoid disproportionate restrictions on cross-border activities which go against Community law and seriously hamper business': EUROCHAMBRES, 'Company Taxation – complement the freedoms of the Single Market to foster the growth of European businesses', p.6.

⁵⁶⁸ CCCTB/RD\004, paragraph 15.

⁵⁶⁹ *Ibid*.

⁵⁷⁰ *Ibid*, paragraph 16.

an escape clause in cases of genuine economic activities, which is something already criticised.⁵⁷¹

6.2.10. As for the relationship between the switch-over clause and CFC rules, in CCCTB/RD\004 the Commission had stated that the CFC rules in the CCCTB function as an adjunct and not as an alternative to the switch-over clause.⁵⁷² By contrast, the draft CCCTB Directive does not refer to the relationship between the two. The fact that one rule is set out in the chapter on dealings between the group and other entities and the other rule is set out in the chapter on anti-abuse rules might even suggest that the two rules have a different function and could be applied simultaneously.

6.2.11. In any case, the new CFC rules, drafted in line with CCCTB/RD\04, provide for the tax base to include the non-distributed income of an entity resident in a third country where the following conditions are met:

(a) The taxpayer, by itself or together with its associated enterprises, control more than 50% of the voting rights or own more than 50% of the capital or be entitled to receive more than 50% of the profit.⁵⁷³

(b) The CFC is tax resident in a low-tax third country, meaning a country which operates under its general tax regime, a statutory corporate tax rate lower than 40% of the average statutory corporate tax rate in the Member States, or a special regime allowing for a substantially lower level of taxation than the general regime.⁵⁷⁴ EEA countries which exchange information to the standard of the Mutual Assistance Directive 2011/16/EU are excluded from the scope of this rule.⁵⁷⁵

(c) The CFC's principal class of shares is not regularly traded on a recognised stock exchange.⁵⁷⁶

(d) More than 30% of the income accruing to the CFC is 'tainted'.⁵⁷⁷ The concept includes certain listed types of revenues⁵⁷⁸ where more than 50% of this category of income is derived from transactions between the CFC and the taxpayer or its associated enterprises.⁵⁷⁹

⁵⁷¹ Also see criticism by Business Europe Task Force, published in its discussion of the switch-over clause under CCCTB/RD\004. The fact that the switch-over clause is not listed with the other Anti-Abuse Rules of the draft CCCTB Directive is unlikely to be sufficient justification, as another anti-abuse provision listed in this chapter (Art 75: Disallowance of Exempt Share Transfers) contains an escape clause.

⁵⁷² CCCTB/RD\004, paragraph 17.

⁵⁷³ Art 82(1)(a) of the draft CCCTB Directive. Also see CCCTB/RD\004, paragraph 19(a). In defining 'control' in CCCTB65, the Commission thought that although various possibilities existed 'probably for the CCCTB the CFC should be considered to be under the control of the resident company if this company controls, direct or indirectly, more than 50% of the voting rights, ownership or capital or entitlement to profits': CCCTB65, fn.362, paragraph 30. Other possibilities referred to are the rules on related parties (20% of voting rights – see CCCTB57, fn.20, paragraph 78) and control as defined in the Parent-Subsidiary Directive. These possibilities should be considered when the >50% threshold is owned by any entities acting in concert.

⁵⁷⁴ Art 82(1)(b) of the draft CCCTB Directive and CCCTB/RD\004, paragraph 19(b). Also see CCCTB/WP057annotated, fn.4, paragraph 128 and CCCTB65, fn.362, paragraph 30 in that a foreign tax rate would be acceptable if it is not less than 40% of the average statutory corporate tax rate applicable in Member States and not being subject to a special regime, resulting in a substantially lower level of taxation.

⁵⁷⁵ Art 82(2).

⁵⁷⁶ Art 82(1)(d) and CCCTB/RD\004, paragraph 19(c).

⁵⁷⁷ Art 82(1)(c) and CCCTB/RD\004, paragraph 19(d). Art 82(1)(c) does not use the term 'tainted' income.

⁵⁷⁸ *Inter alia*, interest, royalties, dividends, income from the disposal of shares, income from insurance, banking and other financial activities, income from movable property or from immovable property. See Art 82(3) of the draft CCCTB Directive. CCCTB/RD\004, paragraph 19(d) had stated that this income would be tainted, unless a DTC was in place, which provided otherwise.

⁵⁷⁹ See Art 82(3) of the draft CCCTB Directive and CCCTB/RD\004, paragraph 19(d). This also seems to follow from the discussion in CCCTB65. In this document, in defining a 'CFC' in CCCTB65, there were two suggestions: a CFC ought to be defined, either by taking into account the fact that the CFC does not *engage in any real economic activity* or by considering *the nature of the income earned* by the CFC (i.e. checking if it is

6.2.12. CFC rules in the CCCTB only apply to subsidiaries resident in a third country.⁵⁸⁰ All non-distributed income of the CFC will be taxable in proportion to the profit entitlement of the taxpayer.⁵⁸¹ Distributed profits and/or proceeds of a share disposal linked to an entity, which has already been taxed by the group as a CFC, will be deducted from the tax base when calculating the taxpayer's liability to tax on the distributed income.⁵⁸² If a CFC is loss-making, the losses will not be incorporated in the tax base of the taxpayer but the CFC will be entitled to carry forward the losses for future years.⁵⁸³

6.2.13. Again, here, the Commission limits the ambit of the rules to third country CFCs. Therefore, it is uncertain whether the same rules would apply if the controlled foreign company was established in a non-CCCTB Member State. This is understandable given that the Commission has drafted the CCCTB proposal on the basis that all Member States would adopt it. In other words, to the Commission, there could only be CFCs established in third countries – there could never be non-CCCTB CFCs within the EU.

6.2.14. As mentioned many times throughout this report, given the hostility of some Member States towards the CCCTB, this is not a very realistic stance to take. There may very well be non-CCCTB Member States with low tax regimes, in which controlled companies may be established. This could create situations of tax arbitrage, which are considered below.

6.2.15. In any case, whatever CFC rules and/or switch-over mechanisms are eventually adopted for the purposes of the CCCTB, their application would still have to comply with the case law of the Court of Justice, mentioned below. This point was reiterated by the Commission in CCCTB65.⁵⁸⁴ Referring to its Communication on anti-abuse measures, the Commission commented that '[t]o comply with the ECJ law either CFC rules are only to be applied in relation with third countries or CFC rules are also to be applied within the EU but, in this case, the rules should be targeted at wholly artificial arrangements only'.⁵⁸⁵

6.2.16. The relevant principles of the case law can be distilled from the following three important cases.

mainly passive income): CCCTB65, fn.362, paragraph 30. The Commission preferred the latter and argued that the CFC should be defined 'considering the nature of the income earned by the company: if a certain threshold of the total income earned by the company is passive income (for example 80%) the company would be a CFC': CCCTB65, paragraph 34.

⁵⁸⁰ See Art 82(1) and CCCTB/RD\004, paragraph 20.

⁵⁸¹ See Art 83(2), dealing with computation. Also CCCTB/RD\004, paragraph 19, which further provided that the non-distributed income of the CFC would be taxable without distinction between active and passive income. This seemed to be contrary to the preference shown by the Commission in CCCTB65 where it was stated that '[o]nce the CFC is identified only the passive income should be integrated in the tax base of the resident company and when the CFC distributes dividends it would be assumed that the dividends are First paid out of the passive income': CCCTB65, fn.362, paragraph 34.

⁵⁸² See Art 83(4) and (5). Also see CCCTB/RD\004, paragraph 16. This is broadly aligned with the Commission's stance in CCCTB65 in that 'there should be relief for the taxes paid abroad and the income that has been taxed in the CFC by being included in the tax base of the resident shareholders should not be double taxed when the dividends are distributed to those shareholders': CCCTB65, fn.362, paragraph 32. The Commission also argued in paragraph 34 that when the CFC distributed dividends, then it should be assumed that these dividends were First paid out of passive income. This is not addressed in CCCTB/RD\003.

⁵⁸³ Art 83(1) and CCCTB/RD\004, paragraph 20.

⁵⁸⁴ See paragraph 29 in CCCTB65, fn.362: '[...] if CFC rules were to be introduced in the CCCTB they should be in line with the recent ECJ rulings'.

⁵⁸⁵ *Ibid*, citing COM (2007) 785.

6.2.17. First, *Cadbury Schweppes*.⁵⁸⁶ This case established that for Member State CFC regimes to be compatible with EU law, the regimes must specifically relate to *wholly artificial arrangements* intended to circumvent the application of the legislation of the Member State concerned.⁵⁸⁷ The specific objective of the restrictive rules must be to prevent conduct involving the creation of wholly artificial arrangements that do not reflect economic reality.⁵⁸⁸ As a corollary, CFC rules must exclude from their scope situations whereby, despite the existence of tax motives, the incorporation of a CFC reflects economic reality.

6.2.18. In determining whether or not economic reality exists in addition to the subjective element, which consists of the intention to obtain a tax advantage, objective circumstances must be taken into account.⁵⁸⁹ These objective factors, which have to be ascertainable by third parties, include, in particular, the extent to which the CFC physically exists in terms of premises, staff and equipment.⁵⁹⁰ The parent company of the CFC must be given the opportunity to produce evidence that the arrangement is genuine.⁵⁹¹

6.2.19. *Cadbury Schweppes* was followed in the *CFC GLO* case.⁵⁹² In this case, the Court of Justice looked at the UK CFC rules.⁵⁹³ An important feature of this case was that the Court of Justice found certain compliance requirements (where the resident company sought exemption from taxes already paid on CFC profits) *not* to be prohibited, as long as their aim was to verify that the CFC was actually established and that its activities were genuine and did not entail undue administrative constraints.⁵⁹⁴ The Court of Justice also held that the resident company was best placed to establish that it had not entered into wholly artificial arrangements, which did not reflect economic reality.⁵⁹⁵ It was up to the national court to determine whether the motive test of the UK CFC legislation lent itself to an interpretation that enabled the CFC charge to be restricted to wholly artificial arrangements.

6.2.20. Incidentally, in *Vodafone 2*,⁵⁹⁶ in the High Court (Chancery Division), Mr Justice Evans-Lombe found that the UK CFC legislation was incompatible with EU law because the motive test⁵⁹⁷ did not ensure that only wholly artificial

⁵⁸⁶ Case C-196/04 *Cadbury Schweppes* [2006] ECR I-7995. For general commentary, see, *inter alia*, R Szudoczky, 'UK CFC Rules Breach Freedom of Establishment unless Application Limited to Wholly Artificial Arrangements' (2006) 11 *European Taxation* 41; Gerrard Meussen, 'Cadbury Schweppes: The ECJ Significantly Limits the Application of CFC Rules in the Member States' (2007) 1 *European Taxation* 13; Simon Whitehead, 'Practical Implications Arising from the European Court's Recent Decisions concerning CFC Legislation and Dividend Taxation' (2007) 4 *EC Tax Review* 176.

⁵⁸⁷ *Ibid*, paragraph 51.

⁵⁸⁸ *Ibid*, paragraph 55.

⁵⁸⁹ *Ibid*, paragraphs 64–65.

⁵⁹⁰ *Ibid*, paragraph 67. Advocate General Léger had explained in greater detail some relevant criteria in establishing artificiality. First, the degree of physical presence of the subsidiary, i.e. examining whether or not the subsidiary has the premises, staff and equipment necessary to carry out the services provided to the parent company. Second, the genuine nature of the activity provided by the subsidiary, i.e. considering the competence of the subsidiary's staff in relation to the services provided and the level of decision-making in carrying out those services. Third, the economic value of that activity with regard to the parent company and the entire group, i.e. whether or not the value reflects the exercise of genuine activities in the state of the subsidiary. Case C-196/04 *Cadbury Schweppes*, paragraphs 111–114 (opinion).

⁵⁹¹ Case C-196/04 *Cadbury Schweppes*, fn.586, paragraph 70 (Court of Justice). The fact that the activities which corresponded to the profits of the CFC could just as well have been carried out by the parent company did not warrant the conclusion that this was a wholly artificial arrangement. More was required. See also paragraph 69.

⁵⁹² Case C-201/05 *CFC GLO*, fn.541.

⁵⁹³ The Court of Justice also looked at the rules on the taxation of inbound dividends and followed the *FII GLO*.

⁵⁹⁴ Case C-201/05 *CFC GLO*, fn.541, paragraphs 82 and 85.

⁵⁹⁵ *Ibid*, paragraph 82.

⁵⁹⁶ *Vodafone 2 v. HMRC* [2008] EWHC 1569 (Ch).

⁵⁹⁷ The motive test, as set out in section 748(3) ICTA, stipulated that the profits of the foreign subsidiary were not to be apportioned to the UK parent 'if it is the case that: (a) in so far as any of the transactions ... achieved a reduction in United Kingdom tax, either the reduction so achieved was minimal or it was not the main

arrangements would be caught by the CFC regime. Therefore, the UK CFC rules had to be disapplied.⁵⁹⁸ This decision was reversed at the Court of Appeal,⁵⁹⁹ which held that the CFC rules should be interpreted as if there was a new additional exception applying with retrospective effect.⁶⁰⁰ This new exception would apply to companies that are actually established in the EU/EEA area and which carry on genuine economic activities there.⁶⁰¹ The concept of 'genuine economic activities' was not defined. For companies established outside the EU/EEA area and for companies established in the EU/EEA area but without genuine economic activities, the normal CFC rules would apply. The case has now been settled.⁶⁰²

6.2.21. In 2010, ECOFIN adopted a resolution on the co-ordination of Member States' tax policies with regard to anti-abuse provisions.⁶⁰³ The resolution recommended that Member States, when applying CFC and thin cap rules within the EU, which are not applicable in similar domestic situations, should adopt some guidelines. These guidelines 'are a political commitment, whose implementation is left to the decision of each Member State, and therefore affect neither the rights or the obligations of the Member States nor the respective competencies of the Member States and of the Union under the Treaty and, in particular, do not require Member States who do not have the types of rules referred to in this Resolution to introduce such rules'.⁶⁰⁴ The guidelines included a non-exhaustive list of indicators suggesting that profits may have been artificially diverted to CFC.⁶⁰⁵ The importance of administrative co-operation was also stressed.

6.2.22. Accordingly, any CFC rules under the CCCTB regime would arguably have to comply with all these principles.

6.2.23. Switch-over clauses appear to be less problematic. In fact, the Court of Justice has held that these clauses do not restrict fundamental freedoms. The case in question was *Columbus Container*.⁶⁰⁶ In this case, the claimant was a Belgian limited partnership with German resident partners. The activities of the

purpose or one of the main purposes of that transaction [and] (b) it was not the main reason or, as the case may be, one of the main reasons for the company's existence in that accounting period to achieve a reduction in United Kingdom tax ...'.

⁵⁹⁸ *Ibid*, paragraph 90.

⁵⁹⁹ *Vodafone 2 v. HMRC* [2009] EWCA Civ 446.

⁶⁰⁰ This was to be added in either section 748(1) or 748(3) of ICTA 1988.

⁶⁰¹ *Vodafone 2 v. HMRC*, fn.599, paragraph 39.

⁶⁰² See David Stewart, 'Vodafone Settles Dispute With HMRC Over Controlled Foreign Corporations', reported in *Tax Analysts* 2010 WTD 142-2.

⁶⁰³ See Draft Council resolution contained in 10597.10 FISC 58, dated 2 June 2010. The resolution was adopted by ECOFIN on 8 June 2010.

⁶⁰⁴ *Ibid*, page 3.

⁶⁰⁵ The list of indicators read as follows:

- 'a. there are insufficiently valid economic or commercial reasons for the profit attribution, which therefore does not reflect economic reality;
- b. incorporation does not essentially correspond with an actual establishment intended to carry on genuine economic activities;
- c. there is no proportionate correlation between the activities apparently carried on by the CFC and the extent to which it physically exists in terms of premises, staff and equipment;
- d. the non-resident company is overcapitalised, it has significantly more capital than it needs to carry on its activity;
- e. the taxpayer has entered into arrangements which are devoid of economic reality, serve little or no business purpose or which might be contrary to general business interests, if not entered into for the purpose of avoiding tax.' *Ibid*, p.4.

⁶⁰⁶ Case C-298/05 *Columbus Container Services BVBA & Co. v. Finanzamt Bielefeld-Innenstadt* [2007] ECR I-10451. For commentary, see generally, J Calderon & A Baez, 'The Columbus Container Services ECJ Case and its Consequences: A Lost Opportunity to Shed Light on the Scope of the Non-Discrimination Principle' (2009) *Intertax* 212; Gerrard Meussen, 'Columbus Container Services – A Victory for the Member States' Fiscal Autonomy' (2007) *European Taxation* 169.

partnership consisted, *inter alia*, of financing subsidiaries and branches. The partnership's profits and assets were, under German domestic tax law, assessed as foreign branch profits and assets of the German partners. In Belgium, the partnership was treated as a company and enjoyed the status of a Belgian Co-ordination Centre.

6.2.24. According to the Belgium–Germany tax treaty, the profits from the net assets of a Belgian partnership were exempt in Germany. However, German anti-abuse rules provided for a switch from the exemption method to the tax credit method in respect of certain passive branch profits subject to low taxation abroad. The key question was whether or not this switch-over clause (technically a treaty override) was compatible with freedom of establishment and free movement of capital.

6.2.25. The Court of Justice, contrary to Advocate General Mengozzi's opinion,⁶⁰⁷ held that such clauses did not constitute a restriction to the freedom of establishment or the free movement of capital. The effect of this rule was that investors who invested in low-taxed jurisdictions were brought to the same position as investors who invested in Germany in so far as tax rates were concerned. The German CFC legislation did not make any distinction between taxation of income derived from the profits of partnerships established in Germany, and taxation of income derived from the profits of partnerships established in another Member State, which subjects the profits made by those partnerships in that State to a rate of tax below 30%. Accordingly, there was no difference of treatment and no discrimination, as 'partnerships such as Columbus [did] not suffer any tax disadvantage in comparison with partnerships established in Germany'.⁶⁰⁸

6.2.26. Arguably, *Columbus Container* leaves considerable leeway for the Member States to switch to the credit mechanism when the controlled subsidiary of a domestic company is in a low-taxed jurisdiction. Consequently, in contrast to the more general CFC rules for which *Cadbury Schweppes* is highly prescriptive, in principle, a CCCTB regime could incorporate a switch-over mechanism with relative ease.

6.2.27. As mentioned earlier, the fact that the current CFC and switch-over rules are limited to third countries only may lead to opportunities for tax arbitrage.

6.2.28. Let us take as an example Cyprus, which has a 10% corporation tax rate. Compared to a CCCTB Member State with a statutory tax rate of >25%, Cyprus may be seen as subjecting CFC profits to less than 40% of the average statutory corporate income tax rate applicable in the Member State of the parent company. If this were a third country, then the CCCTB CFC rules would be triggered following CCCTB/RD\004. However, as this is an EU Member State, then the CCCTB CFC rules are not triggered *ab initio*.

6.2.29. This could mean that intra-EU CFC structures, which qualify as a CCCTB group, would be insulated from attribution of profits or switch-over clauses, even in situations where domestic CFC rules or CCCTB anti-abuse rules would be

⁶⁰⁷ Advocate General Mengozzi had opined that the German switch-over clause restricted freedom of establishment and the free movement of capital. The Advocate General also devoted most of his opinion to considering whether or not the restriction was justified – a question ultimately left for the national court. See opinion dated 29 March 2007.

⁶⁰⁸ *Ibid*, paragraph 40.

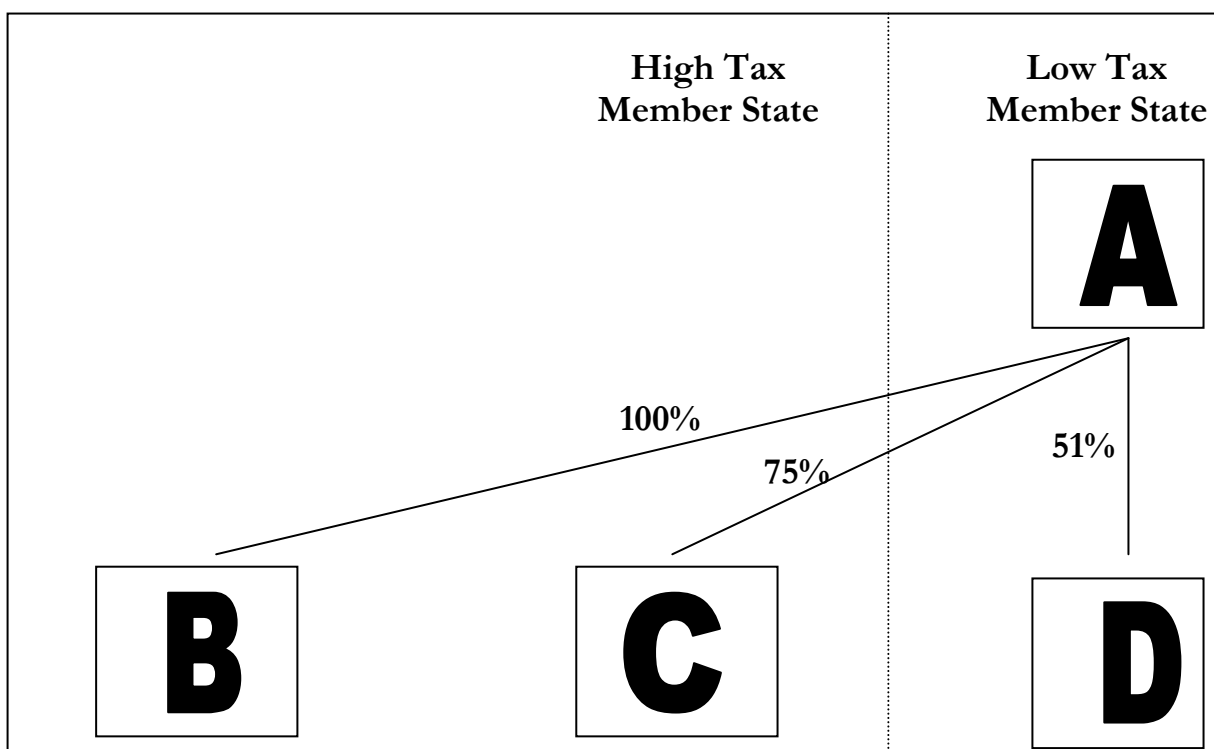
triggered. However, it is still unclear whether the GAAR can be used by the Member State of the parent company to apply its stricter version of anti-deferral rules. It is also unclear whether the application of the GAAR would be more or less justified if the CFC is established in a non-CCCTB Member State rather than a CCCTB Member State.⁶⁰⁹

6.2.30. Another issue arising is whether the non-CCCTB Member State of the parent company of a consolidated CFC in another Member State is obliged to follow the CCCTB anti-abuse rules, as a result of its duties under enhanced co-operation.

6.2.31. Let us assume under the UK CFC rules, profits of an Irish CFC are attributed to the UK parent company, in situations where profits would not be attributed under the CCCTB. If Ireland is a CCCTB Member State and the CFC is part of a CCCTB group, will the UK be able to apply its domestic rules or will it be obliged to defer to the CCCTB rules, even if it is not part of it? Again, in such situations, the GAAR could provide a way to prevent or resolve these conflicts.

6.2.32. Furthermore, the issue of deferral and CFCs could arise in a purely domestic setting given that the threshold for membership and consolidation is relatively high. In such circumstances, there could be non-consolidated controlled group companies within the same CCCTB Member State of one of the consolidated companies.

6.2.33. The following example helps illustrate the point.



⁶⁰⁹ Also see analysis in Part 4 above.

6.2.34. Here, it is assumed that companies A, B and C are consolidated companies. Company D is non-consolidated.⁶¹⁰ Let us assume group profits are artificially diverted to company D, where they are taxed at 10% corporation tax. Had the profits not been diverted away from the consolidated group, then after formulary apportionment, a higher portion of the consolidated tax base could have been allocated to the high tax Member State.

6.2.35. Arguably, here, there is an issue of deferral of profits through a CFC. Since the consolidated profits represent to an extent a mix of domestic and foreign profits, company D is akin to a controlled *foreign* company, being foreign to the consolidated base and a shelter in which otherwise consolidated profits could find their way.

6.2.36. Therefore, CFC issues are likely to be of concern both to low-taxed CCCTB and non-CCCTB Member States.

6.3 Thin capitalisation

6.3.1. Arguably, thin capitalisation is not expected to be an issue between consolidated companies in a CCCTB group, as intra-group loans would be consolidated and interest deductions and receipts netted out. The consolidated tax base would not, therefore, be affected.

6.3.2. Thin capitalisation could, however, be an issue for loans between CCCTB companies and their related parties. This is because when a loan is made by a non-CCCTB parent company to its consolidated subsidiary, then the deductibility of interest from the tax base of the subsidiary would affect the tax base of the consolidated group.⁶¹¹ The same issue may also arise *within* the CCCTB area between consolidated and non-consolidated entities. CCCTB profits represent a mix of both domestic and other Member States' profits requiring that they be treated to an extent as cross-border profits. This could prove to be problematic.

6.3.3. Given that the threshold is now relatively high at 75%,⁶¹² this raises the possibility of related but non-consolidated entities funding the consolidated group, giving rise to interest payments that will reduce the CCCTB profits in favour of the lending entity's national jurisdiction.⁶¹³ In such circumstances, the consolidated group might be over-gearred through the introduction of substantial debt financing from non-consolidated related entities in *low-taxed* areas that are nevertheless within the CCCTB area.⁶¹⁴ This could lead to the reduction of the consolidated base apportioned within the CCCTB area to the benefit of particular low-taxed jurisdictions. Both transfer pricing and thin capitalisation rules are likely to be needed as part of the CCCTB anti-abuse rules to counter such practices.

⁶¹⁰ Company D could voluntarily adopt the new tax base. However, the fact that company D may have to calculate its tax profits on the basis of the CCCTB does not affect the tax rate that would be applied to it. Therefore, mere adherence to the new tax base, without consolidation, is not relevant to this case study.

⁶¹¹ See Malcolm Gammie & Christiana HJI Panayi, 'Inbound Investment and Thin Capitalization', in Lang et al., fn.18.

⁶¹² See Part 2.1.

⁶¹³ The same issue would arise if there are forms of entities that are ineligible for consolidation (e.g. partnerships or companies not listed in Annex 1 of the draft CCCTB Directive).

⁶¹⁴ This is analogous to the situation described immediately above in the section on CFCs: see Part 6.2.

6.3.4. Under the draft CCCTB Directive, expenses incurred by a CCCTB group company (*inter alia*) in the raising of equity or debt for business purposes will be deductible expenses.⁶¹⁵ However, as already pointed out,⁶¹⁶ as an exception to the rule, costs incurred by a company for the purpose of deriving exempt revenue are non-deductible.⁶¹⁷ If costs such as interest were incurred in the raising of debt for business purposes, other than for deriving exempt revenue, they remain deductible.

6.3.5. As a corollary, in principle, interest payable by a CCCTB group company borrowing from a non-CCCTB affiliate (whether in a CCCTB Member State, a non-CCCTB Member State or a third country) will be a deductible expense against the CCCTB group company's tax base. The interest deduction of the individual tax base will become an interest deduction of the consolidated tax base when the individual bases (of consolidated members) are pooled together.⁶¹⁸

6.3.6. A market-based, arm's length interest payment⁶¹⁹ (and the corresponding interest deduction) would not be objectionable to the borrowing company's tax authorities – and the tax authorities of the other consolidated entities who seek to tax their apportioned piece of the consolidated tax base. This involves some common judgment, however, on what will qualify as a market-based, arm's length interest payment because an excessive interest payment would be objectionable either to the tax authorities of the borrowing company and/or⁶²⁰ the other tax authorities that are to share the consolidated tax base.

6.3.7. Therefore, the issue is not just one of depletion of tax base. It is also, potentially, a question of fair play: one investor-friendly CCCTB jurisdiction being very permissive with interest deductions, whilst benefiting from a larger share of the consolidated base as a result of another, less investor-friendly CCCTB jurisdiction being stricter with interest deductions. As succinctly put by the Commission in an earlier general report on the international aspects of the CCCTB, which did not specifically address thin capitalisation: 'A State who (*sic*) unilaterally does not limit deductions of items that another State considers non-deductible would still have a share of the consolidated base which in general had not been reduced. Conversely States who did not allow such deductions would receive a share of the consolidated base reduced by the unilaterally permitted larger deductions.'⁶²¹

6.3.8. Nevertheless, the fact that Member States show a diverse approach towards thin capitalisation practices⁶²² did not prevent the Commission from

⁶¹⁵ Art 12 of the draft CCCTB Directive. Also see CCCTB57, fn.20, paragraph 24.

⁶¹⁶ See analysis in paragraph 2.3.10 of the report.

⁶¹⁷ Art 14(1)(g). Such costs shall be fixed at a flat rate of 5% of that income unless the taxpayer is able to demonstrate that it has incurred a lower cost. This contrary to the suggestion in fn.13 of CCCTB/WP057 annotated.

⁶¹⁸ As explained above, the tax bases of consolidated group members are pooled together to arrive at the consolidated tax base, which will be subject to apportionment.

⁶¹⁹ See the Commission's comments on this. 'In relation to loan transactions the arm's length price would mean an arm's length price based on an arm's length amount. In other words, both the amount of interest and the amount of the loan must be arm's length': CCCTB57, fn.20, paragraph 44.

⁶²⁰ This is because even if the tax authorities of the borrowing company have a relaxed attitude towards interest deduction, the tax authorities of the other consolidated entities may not share this approach, being directly affected by the depletion of their common tax base.

⁶²¹ CCCTB\WP\049\doc\en\rev: 'Report and Discussion on Progress of the Sub-group on International Aspects (An overview of the main issues that emerged at the third meeting of the subgroup on international aspects)' (SG 4) (23/11/2006), paragraph 38. In this report, the Commission had looked at tax base reduction in the general context of deductible items, not just interest reliefs.

⁶²² Some Member States do not recognise thin capitalisation as being an abusive practice (e.g. Cyprus and Malta). Others consider it as an abusive practice but show various degrees of permissiveness in their rules against it, such as the thresholds tests for 'control' or 'connected parties' or 'related parties'.

suggesting that the CCCTB should offer a common solution for thin capitalisation situations.⁶²³ It was perhaps inevitable that the Commission would suggest the introduction of a common solution.

6.3.9. The Commission's recent anti-abuse paper, CCCTB/RD\004, contained a provision designed to achieve the effect of thin capitalisation but only vis-à-vis third country associated enterprises. This was adopted in the draft CCCTB Directive, in Art 81. Similar to the CFC rules, interest paid to an associated enterprise⁶²⁴ in a third country will not be deductible where the statutory corporate tax rate in the third country is lower than 40% of the average applicable in Member States or there is a special regime that allows a substantially lower level of taxation.⁶²⁵ Interest is defined⁶²⁶ almost identically to Art 11(3) of the OECD Model.⁶²⁷

6.3.10. In addition, there must be no exchange of information on request to the standard of the recent Mutual Assistance Directive (2011/16/EU).⁶²⁸ As commented in CCCTB/RD\004, this rule is meant to cover not only cases of 'definitive influence and control' (i.e. freedom of establishment) but also extends to the free movement of capital.⁶²⁹

6.3.11. Interest will still be deductible if the payer has included income of the payee in its tax base under CFC rules and only up to that amount or the payee's principal class of shares is regularly traded in a recognised stock exchange or interest is paid to an entity engaged in the active conduct of trade or business in its country of residence.⁶³⁰ The latter is understood 'as an independent economic enterprise carried on for profit and in the context of which officers and employees carry out substantial managerial and operational activities'.⁶³¹

6.3.12. Associated enterprises, as defined in CCCTB/RD\003⁶³² and subsequently adopted in Art 78 of the draft CCCTB Directive, are a refinement of

⁶²³ CCCTB\WP\019\doc\en, fn.471, paragraph 39.

⁶²⁴ This was different to the approach in CCCTB65, where in considering interest limitation rules, the Commission did not distinguish between situations of excessive interest payments to related parties and to third parties. Both seem to be covered under the Commission's perception of thin capitalisation practices: CCCTB65, fn. 471, paragraphs 16–19. Three possibilities were considered, either as alternatives or combined with each other; namely, earnings before interest and taxes (EBIT) or earnings before interest, taxes, depreciation and amortisation (EBITDA) tests, limitation of interest deductible according to a fixed debt to equity ratio and limitation of interest deductible according to an arm's length basis. None of the suggested rules in CCCTB65 referred to 'related parties' or 'control' or 'connected parties' or 'significant influence': CCCTB65, paragraphs 12–13.

⁶²⁵ Art 81(1)(a) and (b) of the draft CCCTB Directive and CCCTB/RD\004, fn.9, paragraph 11.

⁶²⁶ See definition in Art 81(2) of the draft CCCTB Directive.

⁶²⁷ The only difference between Art 81(2) of the draft CCCTB Directive and Art 11(3) of the OECD Model is that the former refers to 'income from securities' whereas the latter refers to 'income from government securities'.

⁶²⁸ Art 81(1) of the draft CCCTB Directive. As pointed out in CCCTB/RD\004, the relevant treaty in assessing the standard of exchange of information would be the one in force between the States where the CCCTB company and the associated company directly involved in the flow of interest are resident: CCCTB/RD\004, paragraph 13. The discussion document also contained a specific rule to tackle double deductions in the so-called sandwich cases. In these situations, a third country company was interposed between two CCCTB group members (i.e. EU Company 3 was the subsidiary of a third country company, Company 2, which itself was the subsidiary of another EU Company 1). See rule (v), in CCCTB/RD\004, fn.9, paragraphs 25–26. This rule prevented situations whereby Company 1 benefited from a deduction of trading losses (incurred by consolidated Company 3) and made provisions for bad debt. This was because there was a requirement that the third country company be located in a jurisdiction that exchanges information on request to the standard of the Mutual Assistance Directive. Otherwise, the structure would not be eligible for consolidation under the common rules. See paragraph 26. Also see analysis in Part 2.1.9 above.

⁶²⁹ CCCTB/RD\004, paragraph 12.

⁶³⁰ Art 81(3)(a), (b) and (c) of the draft CCCTB Directive and CCCTB/RD\004, paragraph 14.

⁶³¹ Art 81(3)(c) of the draft CCCTB Directive.

⁶³² CCCTB/RD\003, fn.9, paragraphs 16–21. Also see analysis in Part 2.5 above.

the Commission's earlier test of related companies⁶³³ and more streamlined with the OECD Model definition. Under the latest rule,⁶³⁴ apart from permanent establishments and their head office, associated enterprise structures are created when taxpayers participate directly or indirectly in the management or control or capital of a non-taxpayer, or a taxpayer and a non-taxpayer, or a taxpayer in a different group.

6.3.13. The threshold for control is a holding exceeding 20% of the voting rights.⁶³⁵ The threshold for participation in the capital is a participation exceeding 20% of ownership rights.⁶³⁶ The threshold for management is for a position to exercise significant influence in the management of the associated enterprise.⁶³⁷ An individual, his spouse and his lineal ascendants or ascendants are treated as a single person.⁶³⁸

6.3.14. In indirect participations, the requirements relevant to capital and control are fulfilled if the thresholds are reached by multiplying the rates of holding through successive tiers.⁶³⁹ A taxpayer holding more than 50% of the voting rights shall be deemed to hold 100%.⁶⁴⁰

6.3.15. A number of issues ought to be considered regarding the CCCTB's thin capitalisation provisions.

6.3.16. First, it ought to be pointed out that if the CCCTB is adopted by all Member States, then these uniform thin capitalisation rules would be imposed by all CCCTB jurisdictions, even if some jurisdictions do not have such rules in their domestic laws. Following CCCTB/RD\004 and Art 78 of the draft CCCTB Directive, it is now hardly possible that each CCCTB jurisdiction would be able to apply its own domestic version of the rules (if any), unless the escape clause of the CCCTB applies in circumstances where the domestic rules would not have exonerated the transaction. As suggested in the context of CFCs, in such circumstances the GAAR may be used to bridge the differences.⁶⁴¹

6.3.17. If indeed, as a result of the new test, uniform thin capitalisation rules are imposed by all CCCTB jurisdictions, then for some Member States, which do not have such rules domestically, this may be a disincentive to join the CCCTB. Also, because eligible group companies would have the right to elect not to become a CCCTB group, then to an extent these allegedly uniform thin capitalisation rules would not necessarily be uniform or applicable for that matter.

⁶³³ The earlier proposals referred to 'related' companies. CCCTB57 described related companies as companies whose voting rights are owned by more than 20%: CCCTB57, fn.20, paragraph 78.

⁶³⁴ Art 78(1) and (2) of the draft CCCTB Directive. Also see CCCTB/RD\003, fn.9, paragraphs 18–19.

⁶³⁵ Art 78(2)(a) of the draft CCCTB Directive. In CCCTB57 it was stated that '[p]arties are related where one controls the other or is controlled by the other, or they are both in common control.' An individual could also be a controlling party. Directors and relatives would count as related parties. In so far as 'control' was concerned, the Commission in CCCTB57 seemed to have eschewed the case-by-case approach in favour of fixed thresholds; namely, an effective holding or voting rights of at least 20% to be determined by multiplication of the successive rates of ownership. Generally, the Commission preferred 'to adopt a wide concept of control including situations where there is the potential for significant influence': CCCTB57, fn.20, paragraph 78.

⁶³⁶ Art 78(2)(b) of the draft CCCTB Directive.

⁶³⁷ Art 78(2)(c).

⁶³⁸ Art 78(2)(d). It would have been preferable if the provision was not gender specific. Also see more gender neutral provision in CCCTB/RD\003, paragraph 21, which was, however, limited to calculating the influence or control of an individual.

⁶³⁹ See Art 78(2) of the draft CCCTB Directive and CCCTB/RD\003, paragraph 20.

⁶⁴⁰ Art 78(2).

⁶⁴¹ See analyses in Part 4 and Part 6.2.

6.3.18. Member States could still fall back on their domestic rules, if any, when dealing with group companies, which decide not to become a CCCTB group (i.e. to elect out of the CCCTB and, as a corollary, its thin capitalisation rules). If Member States opting in have strict thin capitalisation rules but introduce more lenient rules via the CCCTB, then this may be an incentive for members of a group in that Member State to become a CCCTB group. It may also be an incentive for non-CCCTB group company lenders (whether within the EU or in a third country) to channel their loan through a CCCTB group company in a Member State, rather than a non-CCCTB group company in the same Member State.

6.3.19. Even though following CCCTB/RD\004 and Art 78 of the draft CCCTB Directive it has become clear that from the Commission's perspective these anti-abuse rules are aimed to be uniform and enforced by all Member States – as all Member States are expected to adopt the CCCTB proposal – it is noteworthy that the language used in the CCCTB65 seemed to suggest that the Commission would defer to the discretion of Member State tax authorities in applying the tests.⁶⁴² This is, arguably, aligned with the *SGI* case,⁶⁴³ examined in greater detail below. Nevertheless, it appears to be unclear whether the rules envisaged for the CCCTB are presented as rules that would *allow* tax authorities to re-characterise wholly artificial arrangements, rather than *require* tax authorities to do so. The fair-play implications of this are also discussed below.

6.3.20. A second issue is the effect of the CCCTB thin capitalisation rules being triggered. If the borrowing consolidated subsidiary was found to be thinly capitalised, who would have the power to deny the interest deduction? Would the Member State of the borrower still be able to deny interest deduction or would such action only be taken by the principal tax authority (i.e. the Member State of the principal taxpayer,⁶⁴⁴ where the consolidated tax base would be audited)?⁶⁴⁵ What if the Member State of the borrowing company did not exercise this power of denial of interest deduction? Would the principal tax authority be able to re-adjust the consolidated tax base? Would the tax authorities of the other consolidated entities be able to demand that the final consolidated tax base be re-adjusted?⁶⁴⁶

6.3.21. If the Member State of the borrowing company had sole power to deny interest deduction, then there could be room for manoeuvre for lenders from non-CCCTB countries. For example, loans could be channeled to the final debtor through other consolidated companies in CCCTB countries with a lenient attitude to thin capitalisation practices.

6.3.22. If, however, denial of interest deduction were to be done centrally, then the tax treaty thin capitalisation arrangements between non-CCCTB countries and CCCTB countries could be overridden – assuming these tax treaty

⁶⁴² See, for example, paragraph 6 in CCCTB65, fn.362: 'A general anti-abuse rule could be established in the CCCTB to allow tax authorities to re-characterise wholly artificial arrangements [,,,]'. Also see paragraph 8: 'Establishing only a general anti-abuse rule would provide [Member States] with a flexible tool to combat abusive practices [...]'. Also see paragraph 9: '[...] In the Commission Services' view a combination would provide the tax administrations with easily and straight forward specific rules to combat specific and well known cases of abuse and a general rule could be applied to combat possible abuse that was not foreseen when designing the common rules'.

⁶⁴³ Case C-311/08 *SGI*, fn.147.

⁶⁴⁴ Assuming it is not the same as the Member State of the borrowing company.

⁶⁴⁵ See the proposed arrangement in the CCCTB61, fn.147. This document was released in December 2007.

⁶⁴⁶ See the point on fair play made previously.

arrangements continue to operate in any event.⁶⁴⁷ Non-CCCTB countries (especially third countries) may consider the centralisation of this function as giving rise to a treaty override. There could also be problems intra-EU as a result of the potentially simultaneous application of different thin capitalisation regimes: domestic rules, tax treaty rules, the CCCTB and mainstream EU law (case law and Directives⁶⁴⁸).

6.3.23. As mentioned above, these questions remain unclear, even with the publication of the draft CCCTB Directive.⁶⁴⁹ This could certainly raise issues of tax competition and arbitrage. In interpreting these rules, it is important to strike a proper balance between the power and the duty of denial of interest deduction. If one of the reasons behind the introduction of thin capitalisation rules in the CCCTB context is to ensure fair play between CCCTB jurisdictions, then perhaps a *duty* of denial is more appropriate. If consistently applied, it will obviate the need for centralisation of the function.

6.3.24. As a corollary to the discussion on the power/duty of denial, the power/duty of re-characterisation of the payment and the subsequent tax treatment of this re-characterised payment should also be considered. Ideally, there should be a common rule on this point to avoid manipulation of the thin capitalisation rules. For example, lenders from non-CCCTB countries might choose to channel their loans through CCCTB countries that do not impose withholding taxes on the re-characterised payments or on outbound dividends in general. Of course, given the *de limitis* approach of the Commission regarding the taxation of outbound income in the general context of the CCCTB,⁶⁵⁰ it may be difficult to justify specific rules for re-characterised outgoing payments. The penal nature of such rules could, however, provide the necessary impetus. In any case, the case law of the Court of Justice discussed immediately below would have to be taken into consideration.

6.3.25. A third issue arising is whether the arm's length test is encompassed in the new thin capitalisation provision. The new rules do not seem to distinguish between excessive payments of interest and arm's length payments, in restricting interest relief.⁶⁵¹ The focus is on the low level of taxation in the country of the lender and lack of exchange of information. As a result of these simplified rules, there is no need to assess the debt obligation vis-à-vis the non-consolidated lender/parent. Nor is there any need to consider whether the consolidated company is thinly capitalised by reference to the CCCTB group, or the consolidated group, or on a single entity basis. Whilst there are three escape clauses,⁶⁵² none refers to the arm's length principle. The third escape clause provides that the payee be engaged in the active conduct of trade or business in its country of residence, but this is not quite the same as the arm's length test.

⁶⁴⁷ Tax treaty thin capitalisation provisions would presumably only operate on a state to state basis whereas the CCCTB potentially has to apply by reference to the consolidated group.

⁶⁴⁸ This refers to the provisions of the Interest and Royalty Directive, fn.539. Under this Directive interest payments between certain associated companies are exempt from withholding tax. However, the Directive permits the application of domestic or agreement-based provisions required for the prevention of fraud or abuse. See Article 5 of the Directive. Therefore, in cases of abuse, the default position under the Directive seems to be domestic law and tax treaties.

⁶⁴⁹ By contrast, the language used in CCCTB65 seemed to suggest that Member States will have the *power* to re-characterise wholly artificial arrangements and disallow interest relief, rather than the *duty* to do so.

⁶⁵⁰ See analysis in Part 5.3.

⁶⁵¹ Art 79 of the draft CCCTB Directive provides for adjustment of pricing in relations between associated enterprises where the conditions applicable to these enterprises are different from those that would have been made between independent enterprises. It would appear that this more general stipulation is qualified by Art 81, which pre-emptively disallows all interest deductions when the conditions in Art 81(1) are satisfied.

⁶⁵² Art 81(3) of the draft CCCTB Directive.

The former is akin to a business purpose test, which is a subjective one, whilst the arm's length test is an objective one. Therefore, in applying this escape clause (to third countries), its inherent difference from the arm's length test, upon which any underlying tax treaties are most likely to be based, ought to be taken into account.

6.3.26. In applying this test, if an attempt is being made to strike the fine balance between the business purpose test and the arm's length test, regard ought to be had to the recent *SGI* case,⁶⁵³ a case dealing with *transfer pricing* rules. Here, an interest-free loan and management expenses paid by a Belgian holding company, Société de Gestion Industrielle SA (SGI), to a French subsidiary and a Luxembourg corporate shareholder were automatically added back to SGI's tax base by the Belgian tax authorities.⁶⁵⁴ Had the recipient of the benefits been a Belgian company, there would have been no automatic add back. Following a reference to the Court of Justice, the Belgian rules were found to be compatible with EU law. There was a restriction to the freedom of establishment.⁶⁵⁵ Even though the national legislation was not specifically designed against purely artificial arrangements, it was justified by the objective of preventing tax avoidance, taken together with that of preserving the balanced allocation of the power to impose taxes between Member States.⁶⁵⁶

6.3.27. For the legislation to be proportional, two grounds had to be satisfied. First, in each occasion where there was a suspicion that a transaction went beyond what the companies would have agreed under fully competitive conditions, the taxpayer had to be given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction.⁶⁵⁷ Second, where the consideration of such elements led to the conclusion that the transaction in question went beyond what the companies would have agreed under fully competitive conditions, the corrective tax measure had to be confined to the part that exceeded what would have been agreed if the companies did not have a relationship of interdependence.⁶⁵⁸ It was for the referring court to verify whether the Belgian legislation went beyond what was necessary to attain the objectives pursued by the legislation, taken together.⁶⁵⁹ Therefore, in this important case, the arm's length test did not feature in the Court's discussions. The business purpose test was rather pre-eminent.⁶⁶⁰

6.3.28. A fourth issue arising is whether the new thin capitalisation provision would be extended to structures involving lenders from non-CCCTB Member States, or whether it would be confined to third country lenders. From an EU law perspective, there would not *prima facie* seem to be a problem with such a stance. The case law of the Court of Justice seems to suggest that, in general, third country nationals may not enjoy the same protection under EU law as EU/EEA nationals. This trend was confirmed (and approved) in the Commission

⁶⁵³ Case C-311/08 *SGI*, fn.147.

⁶⁵⁴ Under Belgian law, exceptional or gratuitous benefits given by a Belgian company to a non-resident company were automatically added to the taxable base of the Belgian company, if the recipient company was, directly or indirectly, in a relationship of interdependence with the Belgian company.

⁶⁵⁵ *Ibid*, paragraph 55.

⁶⁵⁶ *Ibid*, paragraph 66.

⁶⁵⁷ *Ibid*, paragraph 71.

⁶⁵⁸ *Ibid*, paragraph 72.

⁶⁵⁹ *Ibid*, paragraph 75.

⁶⁶⁰ For general commentary see Adolpho Jimenez, 'Freedom of Establishment versus Free Movement of Capital: Ongoing Confusion at the ECJ and in the National Courts?' (2010) 6 *European Taxation* 250.

Communication on anti-abuse measures.⁶⁶¹ In this Communication, the Commission reiterated that the centre of gravity in respect of some anti-abuse rules, for example CFC rules and thin capitalisation rules, lies clearly within freedom of establishment. As a corollary, 'Community law does not impose any particular requirements on the legitimacy of the application of such [rules] to transactions outside the EU'.⁶⁶²

6.3.29. Does this mean there would be no thin capitalisation provisions applicable within the EU? This is very unlikely. It has to be remembered that as with the other anti-abuse rules, the Commission has drafted these on the basis that all Member States would join the CCCTB. However, in reality, it is almost definite that there would be abstainers. Therefore, interest payments to an associated lender in a non-CCCTB Member State will be just as much a depletion of the consolidated tax base as payments to an associated lender in a third country.

6.3.30. To the extent that the Commission's new test contains an escape clause based on commercial justification, then this would seem to be an appropriate test. This is because under the Court's case law, thin capitalisation rules that target wholly artificial arrangements and are suitable and proportional are compatible with EU law.⁶⁶³ For the rules to be proportional, an affected taxpayer has to be given the opportunity to prove the commerciality of the arrangement without undue administrative constraints.⁶⁶⁴ Also, only the excess interest payment may be re-characterised.⁶⁶⁵ However, the same principles are not necessarily applicable to third country parent companies lending to their CCCTB subsidiaries, as such lenders have less protection following the *Thin Cap GLO*.⁶⁶⁶

6.3.31. Therefore, in principle, there could be variable application of thin capitalisation rules in the CCCTB context: more lenient rules could apply to non-CCCTB EU lenders and stricter ones could apply to third country lenders. If indeed different regimes apply vis-à-vis third country and EU lenders, then this could lend more (theoretical) support to the argument that the tax treatment of income into and out of the CCCTB zone may differ according to whether the origin or the destination of the investment is outside the EU.

⁶⁶¹ See fn.545.

⁶⁶² *Ibid*, p.8. It is only when the application of such rules is not confined to situations and transactions between companies where one has definite influence over the other, that the free movement of capital (and its protective scope vis-à-vis third countries) may be used.

⁶⁶³ See, for example, Case C-524/04 *Thin Cap GLO*, [2007] ECR I-2107; Case C-492/04 *Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen* [2007] ECR I-3775; Case C-105/07 *NV Lammers & Van Cleeff v. Belgian State* [2008] ECR I-11779. Compliance with the Court's case law was confirmed by the Commission in paragraph 29, CCCTB65, fn.663: '[...] if CFC rules were to be introduced in the CCCTB they should be in line with the recent ECJ rulings'. Also see the Commission's general communication on anti-abuse measures, COM (2007) 785.

⁶⁶⁴ Case C-524/04 *Thin Cap GLO*, fn.663, paragraph 82.

⁶⁶⁵ *Ibid*, paragraph 83.

⁶⁶⁶ In this case, the Court of Justice found that only freedom of establishment was relevant to the UK thin capitalisation legislation. This meant that third country companies were not protected. The Court of Justice looked at a number of sub-scenarios in which the debtor company was owned by a non-EU/EEA parent company and the loan was granted either by another Member State group company, or the non-EU/EEA branch of such Member State group company, or a non-EU/EEA group company altogether. Freedom of establishment was not applicable in any of these situations. This was because the thin capitalisation legislation affected freedom of establishment 'not as regards the lending company, but only as regards the parent company which enjoys a level of control over each of the other companies concerned allowing it to influence the funding decisions of those companies' (paragraph 99). As the parent company was in a third country in all of these situations, there was no protection under freedom of establishment. Therefore the UK thin capitalisation rules could not be impugned. For an analysis of the case, see Christiana HJI Panayi, 'Thin Capitalisation GLO *et al.* – A thinly concealed agenda?' 35 [2007] *Intertax* 298. Also see Christiana HJI Panayi, 'The Fundamental Freedoms and Third Countries' 48 [2008] *European Taxation* 571.

6.3.32. With the hindsight of this discussion, what should a non-CCCTB EU lender such as a UK lender be wary of? First, it will have to be examined whether any thin capitalisation rules affecting it (as interpreted and applied) comply with the principles set out in the case law mentioned above. Therefore, it would have to be ensured that there is an escape clause exonerating commercial arrangements. The thin capitalisation rules would also have to comply with the Interest and Royalty Directive. The latter seems less problematic since the Directive explicitly defers to domestic or agreement-based anti-abuse provisions.⁶⁶⁷

6.3.33. Second, it will have to be examined whether the application of the draft CCCTB Directive's thin capitalisation rules would lead to a tax treaty override. This would require an assessment of the thin capitalisation provision of the 'Interest' article found in the UK's tax treaties with CCCTB Member States.

6.3.34. The tax treaty thin capitalisation provision usually replicates that of the OECD Model. It would have to be examined whether in applying the CCCTB test this would go beyond the arm's length principle on which the tax treaty thin capitalisation rules are usually based. Therefore, to the extent that interest re-characterised under the CCCTB thin cap rule would not have been re-characterised under the applicable tax treaty, this could lead to a breach of the tax treaty.

6.3.35. Issues could also arise if a CCCTB group company lends money to a UK group company, as interest relief and other finance expenses that can be deducted in computing the chargeable profits of the UK company may be restricted under the worldwide debt cap rules. These rules were introduced as part of the package for the reform of the taxation of foreign profits in Schedule 15 of Finance Act 2009.⁶⁶⁸ Broadly, the restrictions apply where the UK financing costs exceed the total consolidated external financing costs of the worldwide group. Only large⁶⁶⁹ groups containing at least one company resident in the UK or a company with a UK permanent establishment are subject to the rules.⁶⁷⁰ Under the gateway test,⁶⁷¹ the UK net debt⁶⁷² of the group must exceed 75% of the worldwide gross debt of the group in any accounting period for the rules to apply.

6.3.36. A problem may, however, arise if the text of the CCCTB Directive, as finally adopted (if adopted), contains much more lenient or vague rules for interest relief, or the rules are interpreted as such, compared to the UK debt cap. Let us assume, by way of example, that interest relief on a loan from a CCCTB group company to a UK group company is restricted under the debt cap rules, but in an identically reverse scenario (i.e. UK lender, CCCTB company borrower), interest relief would not have been restricted.

⁶⁶⁷ See Article 5 of the Directive, mentioned in fn.648.

⁶⁶⁸ The rules have now been rewritten into Part 7 of the Taxation (International and Other Provisions) Act 2010. They apply in addition to the UK transfer pricing rules. Therefore, the debt cap could deny a tax deduction even where transfer pricing rules have been complied with.

⁶⁶⁹ A 'large' group is determined by reference to the Annex to Commission Recommendation 2003/361/EC of 6 May 2003. Broadly, this means that the group as a whole either employs 250 or more people or, if not, has an annual turnover of at least £50 million and an annual balance sheet total of £43 million or more.

⁶⁷⁰ Paragraph 86(2) of Schedule 15, Finance Act 2009.

⁶⁷¹ See Part 2 of Schedule 15, Finance Act 2009.

⁶⁷² The UK net debt is the total of the average net debt of each UK company (i.e. relevant liabilities less relevant assets) over the accounting period in question. Net debts of £3m or less for individual companies are ignored. See Edwards, fn.503, Chapter 2.

6.3.37. This could be perceived as a breach of the UK's duties under enhanced co-operation, depending, of course, on the extent of those duties, as to be determined possibly at a later stage. If this is the case, and assuming the debt cap rules are otherwise compatible with general EU law, then there could be different treatment of CCCTB lenders and non-CCCTB EU lenders. The problem could be even more accentuated if the non-CCCTB EU lender is resident in the same Member State as the CCCTB lender, but has simply chosen not to become a CCCTB group.

6.3.38. On the other hand, if Member States opting out are allowed to have stricter thin capitalisation rules from those applicable under the CCCTB – but still compatible with general EU law – then this may be a disincentive for Member States to adopt the CCCTB. By contrast, as already mentioned,⁶⁷³ if Member States opting in retain their stricter thin capitalisation rules but introduce more lenient rules via the CCCTB, then this may be an incentive for members of a group in that Member State to become a CCCTB group.

6.3.39. As already mentioned above,⁶⁷⁴ the GAAR could provide a method to bridge the differences between domestic and CCCTB thin capitalisation rules, though this is not certain yet.

⁶⁷³ See analysis in 6.3.12 et seq.

⁶⁷⁴ See analysis in Parts 4, 6.1 and 6.2 above.

7. Conclusions

7.1.1. This report examined the European Commission's draft plans to introduce a Common Consolidated Corporate Tax Base (CCCTB) for EU group companies. It analysed the basic features of the draft CCCTB Directive and the possible effects of these on the UK tax system.

7.1.2. The key features of the CCCTB were considered in Part 2 of the report. The test for membership/consolidation has been simplified following the recent discussion document on the CCCTB eligibility tests (CCCTB/RD\001) with a single test – albeit a two-part one. There are no longer non-consolidated CCCTB companies, as the same test applies for membership and consolidation. This clarifies matters to a great extent and avoids some overlaps between CCCTB rules and domestic rules, such as would be the case with non-consolidated CCCTB member companies.

7.1.3. Furthermore, the report explained in Part 2 the type of structures that are eligible for consolidation under the draft CCCTB Directive. Broadly, a resident taxpayer can form a group with all its qualifying EU subsidiaries, all its EU permanent establishments and all permanent establishments located in a Member State of its qualifying subsidiaries resident in a third country. A non-resident taxpayer could form a group in respect of all its permanent establishments located in Member States and all its qualifying subsidiaries resident in one or more Member States (and their EU permanent establishments). Although the existence of an intermediary non-CCCTB company does not seem to break the group for consolidation purposes, it is currently uncertain whether this rule would apply if the intermediary is in a third country, which does not have effective exchange of information provisions. Whilst this is not a requirement under the draft CCCTB Directive (it is only a requirement for the rule on disallowance of interest deductions), it was a requirement under CCCTB/RD\001. However, this was just a discussion document, not binding on the Commission. Technically, the absence of such a criterion in the provision for formation of a CCCTB group means that lack of exchange of information is not a vitiating factor. However, this point should preferably be clarified by the Commission.

7.1.4. The report also considered the relationship between the consolidated group and associated companies. It was found that even though such companies are external to the consolidated group, they still bring to the fore issues such as how to combine and co-ordinate formulary apportionment with transfer pricing. Even though intra-group transactions are eliminated, transfer pricing would continue to be relevant in some circumstances. For example, associated enterprises that are not part of the consolidated group would have to apply transfer pricing rules. This would include all non-CCCTB group companies that are associated enterprises, even if they are within the same Member State or in a non-CCCTB EU Member State. The effect of this is that in some situations, adjustments and corresponding adjustments could be made between associated enterprises, which may be contrary to the underlying tax treaty arrangements. Whilst it is stated in the draft Directive that the CCCTB overrides all incompatible agreements between Member States, the application of this rule may bring some uncertainty in the context of non-CCCTB Member States and third countries. Examples of this were given in Part 2.5 of this report.

7.1.5. Optionality was also discussed in Part 2.2 of the report. It was shown that the CCCTB is likely to be optional at numerous levels. Member States may get to choose whether to adopt it or not. They may also get to choose whether to adopt it as their single tax base or as an additional tax base. Furthermore, in Member States adopting the CCCTB, group companies will have the choice whether to become a CCCTB group (if they satisfy the membership test) or not. Therefore, the CCCTB introduces many opportunities for tax planning and tax arbitrage. What the Commission does not address, however, are the costs from this optionality such as the corporate costs of running two systems (including the transfer pricing issues) and/or monitoring to see whether to become a CCCTB group, as well as the costs of the tax authorities in administering two systems. Neither does the Commission address the costs of the transition to the new tax base. These cost calculations are crucial in convincing Member States as to the overall efficiency of the CCCTB.

7.1.6. In looking at the new tax base, many questions arise, as shown in Part 0. Will the new base be applied uniformly by Member States, especially if the starting point – i.e. the accounting rules – and the bridging rules are different? The relationship between financial accounting and tax accounting is not the same in all Member States, with variable degrees of dependency relationships. Some Member States have raised concerns that, unless the proposal sets out a methodology of reconciling financial and tax accounts, there could be an inconsistent calculation of the tax base by Member States. Furthermore, concerns have also been raised in that some Member States would potentially have to comply with at least three sets of tax accounts: the CCCTB, individual company accounts based on national GAARs and consolidated accounts based on IAS/IFRS. It is regrettable that the Commission has not done any more work on the link between accounts and taxable profits.

7.1.7. In addition, Member States would have to compare their own tax base with the CCCTB to see if abstaining from adopting the CCCTB will be at their disadvantage and/or if the two bases can co-exist without eroding each other. Another issue is the transition to the new system, especially if the new tax base replaces the domestic one. What would happen to reliefs under the domestic system (e.g. capital allowances) and pending charges? All these questions are left unanswered. To an extent, it is not easy to answer them in abstract, before the new tax base is applied.

7.1.8. Formulary apportionment, a salient feature of the CCCTB, was also discussed in Part 2.6 of this report. The three-factor formula suggested by the Commission in CCCTB/WP060 and subsequently adopted in the draft CCCTB Directive was criticised for excluding intangible assets and for including sales by destination. This choice of allocation keys appeared to favour groups with no material fixed assets but with intangible assets within the EU, with a highly mobile employee base and with sales being made from outside the EU. It was commented that the Commission has not addressed these concerns in drafting the CCCTB Directive, nor has it produced an impact report justifying the selected factors, even though formulary apportionment is a crucial consideration for Member States participating in the CCCTB.

7.1.9. Another important aspect of the CCCTB is the availability of cross-border loss relief. The rules were explained in Parts 2.4 and 3.2 of the report and

contrasted with the UK group relief rules. It was questioned what the status and ambit of the UK group relief rules are now as a result of the case law and Commission infringement proceedings, and whether this is very different from the CCCTB. The simultaneous application of the case law of the Court of Justice with consolidation under the CCCTB also raised a few issues in the context of non-CCCTB Member States. It was questioned whether the rule that losses of a CCCTB group are to be carried forward indefinitely, could be modified when the *Marks & Spencer* principle applied to allow such losses to be surrendered to a profitable non-CCCTB EU parent company or whether such CCCTB losses would be effectively insulated. It was also questioned whether losses of a non-CCCTB EU affiliate could ever be offset against the overall profits of a CCCTB group, or whether they would be stranded. This could be especially problematic if such losses could have otherwise been absorbed by the non-CCCTB EU parent of the CCCTB group.

7.1.10. Similarities and differences between the two systems were examined in more areas (intra-group transfer of assets, reorganisations, participation exemption) in Part 3, in the context of the Commission's recent discussion documents and the draft CCCTB Directive. It was shown that although the rules have improved, still the CCCTB rules are less complex than the UK rules and much vaguer, possibly giving rise to tax avoidance.

7.1.11. The draft CCCTB Directive contains rules for pre-entry and post-exit asset disposals, to ensure that the consolidated tax base is not distorted with the addition of gains that should have been attributed to a group member and the reverse – it should not miss out from some post-exit gains made by former group members when such gains are thought to belong to the consolidated tax base. There are also special rules for self-generated intangible assets, as well as rules for business reorganisations. Broadly, the draft CCCTB Directive tries to strike a balance in that gains which it considers to be of a 'pre-entry' nature are ring-fenced from the consolidated tax base and gains, which it considers to belong to the consolidated tax base are ring-fenced therein. It was also noted that the rules are quite mechanical and could fall foul of the proportionality test, as they do not provide an escape clause on the basis of commercial justification.

7.1.12. The major differences detected were in the administration of the two systems: the UK being understandably territorial whereas the CCCTB is supranational. It was argued that the difficulties of moving to such a 'supranationally' administered system were exacerbated by the fact that the CCCTB administration rules were at places not very well developed, being quite novel. It is obvious that the draft CCCTB Directive provides an extensive mechanism for the sharing of information between competent authorities. As explained in Part 3.5.2, the centralised database and the overall structure of Chapter XVII of the draft CCCTB Directive suggest that the flow of information under it is likely to be continuous and automatic. Furthermore, onward transmission of third country information is a possibility.

7.1.13. Whilst this goes beyond the existing mechanisms of administrative co-operation in the field of direct taxes (e.g. tax treaties and Directive 77/799), it is, to an extent, aligned with the recently adopted EU Council Directive 2011/16/EU on exchange of information. However, until the latter comes into force, the system introduced in the draft CCCTB Directive will remain something of a novelty, raising concerns among CCCTB group members, whether sufficient safeguards will be applied by Member State competent authorities and whether

their rights will be protected under the CCCTB. It has already been argued that the secrecy clause of the draft CCCTB Directive may not go far enough to ensure that the principle of confidentiality is protected and that Chinese walls are preserved.

7.1.14. One way of meeting some of these concerns is for the competent authorities of all Member States to set up designated CCCTB units which will be uniquely involved in the application of the CCCTB and will have exclusive access to CCCTB information. It would also be helpful if the Commission adopted further guidelines on some of these important issues to deal with the technicalities (and sensitivities) of a cross-border tax audit. As mentioned in Part 3.5.2, further supplementary work is needed for the administration rules to function. To a large extent, the success or failure of the CCCTB depends not only on the perfect drafting of the substantive rules but also on the workable and fair nature of the enforcement methods. This also helps Member States gauge the administrative costs of adopting the CCCTB.

7.1.15. If the UK decides to adopt the CCCTB, then it would have to take into account the above issues. As was explained in Part 4 of the report, if the UK adopts the CCCTB, then the two systems may not always be mere alternatives. Given the high threshold test of membership, there could be situations where a UK group and a CCCTB group co-exist as part of a larger group. In such circumstances, the two systems may be simultaneously applied (e.g. the arm's length principle and formulary apportionment, if there are associated non-consolidated companies) in a harmonious way or in a conflicting way. Examples of such situations were given in Part 4 but also in Part 6, which looked at the anti-abuse rules.

7.1.16. One of the major weaknesses of the Commission's project identified in this report is the fact that it does not factor in the possibility of Member States opting out of it. Ironically, this is the only issue that the Commission cannot 'work on' for the time being, perhaps because it fears that such discussion might boycott the whole project. The Commission seems to believe that unless it proceeds on the assumption that all Member States will adopt the CCCTB, then the proposal will not muster enough support or interest to be considered by Member States, even for partial implementation. Whilst this is an understandable position, it does disservice to the whole project, as it leaves it with large gaps in the analysis. This is especially the case with the rules on the taxation of inbound and outbound investment, as well as the anti-abuse rules, reviewed in Parts 5 and 6 respectively. These rules apply only vis-à-vis a CCCTB Member State company and a third company and are to be uniformly applied by (CCCTB) Member States.

7.1.17. For example the rules on inbound and outbound taxation do not clarify how conflicts between the CCCTB rules and the treatment under tax treaties with non-CCCTB Member States are to be dealt with. In Part 5, a number of examples were given of such conflicts, both from an outbound and an inbound perspective. Obviously, as a corollary of the supremacy of EU law, the CCCTB Directive overrides conflicting provisions in tax treaties between participating Member States. This is expressly stated in the draft CCCTB Directive (Art 8). Conversely, as clarified in the recent discussion document on inbound and outbound investment (CCCTB/RD\003), rights and obligations arising from agreements between Member States and third countries concluded before the CCCTB Directive entered into force will not be affected. This is assumed to be the position under the draft CCCTB Directive. How about rights and obligations arising in tax treaties between

CCCTB and non-CCCTB Member States? How does the duty of non-impediment arising under the enhanced co-operation procedure (buttressed by the general duty of EU loyalty) translate in this context? Will non-CCCTB Member States be under such obligations so as to be effectively applying the CCCTB in their relationships with CCCTB Member States, even though they opted out? Will they have to renegotiate their tax treaties with CCCTB Member States?

7.1.18. Similar problems arise in the area of anti-abuse rules, examined in Part 6, as these only apply vis-à-vis third country companies only. CCCTB/RD\004 and the draft CCCTB Directive set out a general anti-abuse rule (a GAAR) and specific anti-abuse rules, with some of them containing an escape clause and others not. However, the actual scope of the GAAR was not clarified. Neither was the overlap between the specific anti-abuse rules, the GAAR and domestic rules clarified, for instance when it came to non-CCCTB EU parent companies of CCCTB CFCs (and vice-versa) and non-CCCTB EU borrowers from CCCTB lenders (and vice-versa). Examples were given in the report with a suggested analysis on the approach to be followed. General issues pertaining to the drafting of CCCTB CFC rules and thin capitalisation rules were also discussed.

7.1.19. Even if we assume that all these weaknesses are somehow overcome and the CCCTB is launched, each Member State, including the UK, will have to decide whether to opt in or opt out of the CCCTB. Whilst in most cases the decision is likely to be mainly a political one, it is still crucial to reflect on the differences between the two systems, so as to anticipate as much as it is possible whether staying outside of the CCCTB zone will bring about a competitive disadvantage to the UK. It is also crucial to reflect how the domestic system and the CCCTB system can co-exist within one legal order. Most importantly for the UK, which was considering opting out at an earlier stage of the project, is to consider what its rights and obligations will be as a non-CCCTB Member State.

7.1.20. Certainly, the Commission should be congratulated for its work so far and for its perseverance in delivering on its flagship project. Certainly, the publication of the draft CCCTB Directive has produced a lot of momentum in the international tax community and has helped focus the overall discussion in a way that the technical discussion documents did not. However, it is tentatively suggested that further work is needed in the areas pointed out above and throughout this report, in order to convince the possible abstainers, such as the UK, that the CCCTB proposal is workable and viable to be considered for adoption.

7.1.21. It would also help if the Commission released its views on what the legal position of non-CCCTB Member States is likely to be, rather than leave it for later, or worse, leave it to the Court of Justice. That way, Member States could make informed decisions as to whether it would be more suitable for them to opt in or opt out of the CCCTB. It was shown in this report that the possible implications of the Member States' obligations under the enhanced co-operation procedure are not insignificant. Non-CCCTB Member States may lose out on the benefits of the CCCTB while being burdened with a (positive) duty not to impede its implementation. Currently, the actual rights and obligations of non-CCCTB Member States under the CCCTB are unclear. Rather than bestow more confidence on the Commission's project, this creates more uncertainty among Member States as to the true ramifications of the CCCTB. It compromises legal certainty and encourages more Member States to just 'wait and see' with what happens with the ones who join, if any. Comprehensive legislative initiatives such as the CCCTB, if they are to be encouraged, ought to be thoroughly examined,

leaving no scope (or as little as is possible) to uncertainties and loopholes for participating and non-participating Member States.

7.1.22. At the same time, it is suggested that all Member States consider afresh whether to adopt the CCCTB, on the basis of legal and economic grounds, rather than political ones or entrenched positions. The economic studies show the complexities of trying to delineate who will be the winners and the losers from the CCCTB. Perhaps there will not be clear winners and losers. Most likely, the tax community (taxpayers and tax authorities alike) will adjust to the new situation, limiting gains and losses for either party. In fact, the Commission encourages Member States to adopt a different tax rate for the CCCTB if their own national base is extremely different and if by doing so, they maintain the same effective tax rate (and as a corollary, ensure their tax bases are not heavily depleted). The CCCTB is meant to create more transparency with regard to the effective corporate tax situation in Member States, thus creating fairer tax competition within the EU and boosting EU competitiveness globally. In other words, it is meant to be for the benefit of EU tax authorities and taxpayers – not to their detriment.

7.1.23. Another thing to note is that, because of developments in the international tax field, in some areas we are moving to closer tax integration anyway. For example, the current trend is for more extensive exchange of information between tax authorities and transparency. With the developments occurring at OECD level and the adoption of the new Directive on exchange of information (2011/16/EU), some aspects of the administration of the CCCTB will not appear to be so groundbreaking. Most importantly, one cannot ignore or predict the effect of future case law of the Court Justice on Member State tax systems. It may be the case that the principles derived from the Court's jurisprudence erode these tax systems to a much greater extent than the CCCTB – and in a much more random and arbitrary way. Instead of pre-emptively rejecting any proposals for reform and further integration such as with the CCCTB, it may be worth considering first whether the international tax community and the European tax community are heading towards that direction (or a similar direction) anyway.