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**Research Report**

## The European Commission's CC(C)TB re-launch

ZEW policy brief, No. 1/2017

**Provided in Cooperation with:**

ZEW - Leibniz Centre for European Economic Research

*Suggested Citation:* Nicolay, Katharina; Spengel, Christoph (2017) : The European Commission's CC(C)TB re-launch, ZEW policy brief, No. 1/2017, Zentrum für Europäische Wirtschaftsforschung (ZEW), Mannheim

This Version is available at:

<https://hdl.handle.net/10419/149907>

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# ZEW policy brief

by Prof. Dr. Katharina Nicolay and Prof. Dr. Christoph Spengel

## The European Commission's CC(C)TB Re-Launch

### 1 Essential Issues

With its Action Plan for a Fairer and Efficient Corporate Tax System (COM (2015) 302) published on 17 June 2015, the European Commission relaunched the idea of a Common Consolidated Corporate Tax Base (European Commission (2015a)). The respective proposals for a Council Directive have recently been published on 25 October 2016 (COM (2016) 683 and 685). The CCCTB promises a harmonized set of rules to determine the tax base, the consolidation of taxable profits at the EU level and formula-based apportionment. The CCCTB does not harmonize corporate income tax rates, which remain within the purview of the Member States.

[Action Plan for a Fairer and Efficient Corporate Tax System](#)

- ▶ We support the idea of a CCTB to promote the harmonization of corporate income tax bases within the EU.
- ▶ We also support the idea of a two-step approach, i.e. harmonizing corporate tax bases and postponing consolidation and formula apportionment. A mandatory CCTB is clearly superior to an optional CCTB in terms of compliance and administrative costs as well as revenue consequences.
- ▶ The regulations laid out in the 2011/2016 proposal for a Council Directive provide a carefully prepared framework for a common tax base and are generally in line with the practices of EU Member States.
- ▶ The newly introduced elements such as the AGI, an R&D super-deduction and a temporary cross-border loss relief regime, however, narrow the tax base. Although these elements may improve the efficiency of tax systems in the EU, associated revenue losses might require an increase in tax rates.
- ▶ Aligning anti-avoidance legislation reduces negative spill-overs for tax competition within the EU. Nonetheless, regarding tax competition with locations outside the EU, any anti-avoidance legislation that increases the tax burden on profitable investments can have a negative effect on location decisions.
- ▶ Including profit consolidation and formula apportionment in a second stage eliminates profit shifting within the EU. At the same time, there is evidence that this could result in new discretion for tax planning, in particular with respect to factor allocation.

[Key Messages](#)

## Staged Introduction of a CCCTB

The CCCTB was initially put forward in a Proposal for a Council Directive (COM (2011) 121/4) in 2011 with the aim of reducing tax obstacles to an integrated European Market (European Commission (2011)).

In contrast to the 2011 Proposal for a Council Directive, the Commission now envisages a staged introduction of the CCCTB. More precisely, the first stage consists of a common corporate tax base (CCTB), while consolidation and formula apportionment – the reform element removing any incentive for intra-EU profit shifting – are postponed to a later stage. Also different to the 2011 proposal, the 2016 proposal puts forward a mandatory application of the CCCTB for groups with total consolidated group revenue of more than EUR 750.000.000. With respect to the definition of the harmonized tax base, changes to the 2011 proposal include an allowance for growth and investment (AGI) to address the tax discrimination of equity financing, a super-deduction for R&D costs, a temporary cross-border loss relief regime with recapture as well as specific anti-avoidance measures.

The postponed second stage, i.e. consolidation and formula apportionment, provides for a fundamental switch from single entity taxation to unitary taxation of EU groups thus reflecting the growing relevance of multinationals' cross-border activities and the EU as an integrated market. It raises, however, new issues such as potential tax competition on apportionment factors, revenue redistribution, and the responsibilities of local fiscal authorities.

## 2 The First Stage: CCTB Rules for Harmonizing the Corporate Income Tax Base in Europe

### 2.1 Comparative Analysis of the CCTB Proposal for Domestic Tax Accounting Practice

The Commission's Proposal for a Council Directive (COM (2016) 683 and 685) provides a carefully prepared framework for a harmonized determination of corporate taxable income. A study conducted by EY, ZEW and the University of Mannheim compares tax base rules proposed by the 2011 Proposal for Council Directive (COM (2011) 121/4) with prevailing corporate tax accounting regulations (as of 1 January 2011) and presents evidence on the extent of differences and similarities (Spengel et al. 2012). Overall, the proposed rules are in line with commonly accepted principles of tax accounting. Nevertheless, for several Member States differences exist in the recognition and measurement of provisions, in depreciation rates and methods, in capital gains taxation as well as in tax relief for losses.

The CCTB also harmonizes anti-avoidance legislation. This is a reasonable step given the fact that elements removing intra-EU profit shifting, i.e. consolidation and formula apportionment are postponed to a later stage. The proposed rules are generally in line with country practice. Aligning the strictness of anti-avoidance legislation between the Member States reduces negative spill-overs for tax competition within the EU. Nonetheless, regarding tax competition with locations outside the EU any anti-avoidance legislation that increases the tax burden on profitable investments can have a negative effect on location decisions. The rules complement the EU initiatives to increase tax transparency, e.g. via country-by-country reporting.

One important advantage of a CCTB is the likely reduction of compliance and administrative costs in the medium and long term. In this context, a mandatory CCTB is clearly superior to an optional CCTB as proposed by the Draft Directive of 2011. According to the impact assessment of the recent proposal, compliance cost savings of the CCTB amount to 10% in compliance time and 2.5% in compliance cost (SWD (2016) 342).

## CCTB Reduces Compliance and Administrative Costs

## 2.2 Quantitative Impact Assessment of a CCTB

Spengel et al. (2012) quantify the change in effective tax burdens induced by the introduction of a CCTB in each of the 27 EU Member States for the fiscal year 2011. Calculations are based on the European Tax Analyzer, allowing tax base regulations to be modelled in great detail and thus making it easier to assess the timing effects of these regulations. The study does not quantify the impact of cross-border loss offset or any measure to counter the debt-bias or R&D super-deductions since these were not part of the 2011 Proposal for a Council Directive. The change in the EU-27 average tax burden caused by the remaining CCTB measures is rather small (-0.06%). This average effect hides more substantial tax consequences at the national level. The changes in effective tax burdens range from an increase of 3.12% in Romania to a reduction of 4.04% in Cyprus. In Germany and France, the average firm's tax burden changes only slightly, decreasing by -0.16% and 0.15% respectively. With respect to the cross-country difference in effective tax burdens, the distribution remains widely dispersed under a CCTB since profit tax rates are not harmonized. The incentives for tax planning in terms of location decisions and profit shifting thus remain intact. The advantages of a pure harmonization of the tax base include increased transparency, the elimination of qualification conflicts and the reduction of compliance costs. It is, moreover, a prerequisite for cross-border loss offset.

In Germany, these results are corroborated in a study commissioned by the German Federal Ministry of Finance. In this study, ZEW researchers investigated the impact of the CCTB Draft Directive of 2011 on the tax burden of a large sample of German corporations and tax revenue based on the microsimulation model ZEW TaxCoMM (Oestreicher et al. 2013). This study goes beyond average tax effects and illustrates the heterogeneous impact a CCTB might have on firms with different characteristics. The majority of firms experienced a reduction in tax payments. This is mostly attributed to the earlier deduction of allowances, especially the generous pool depreciation, which is now more restrictive in the current proposal. Firms making use of the German tax loss carryback regulations – not applicable under a CCTB – are likely to experience an increase in tax payments, especially if they have a below-average share of depreciable assets and provisions.

**Calculations Based on the European Tax Analyzer**

## 3 A CCTB for the Systematic Removal of Debt Bias in Tax Systems?

In its action plan (COM (2015) 302), the EU Commission criticizes the way conventional tax systems distort financing decisions in favour of debt-financing. To address this shortcoming in a coordinated way, the 2016 proposal for a CCTB (COM (2016) 683) includes a specific form of an allowance for corporate equity (ACE), which is similar in scope to the Italian ACE regime. The proposed Allowance for Growth and Investment (AGI) provides an allowance for the increases in equity compared to a reference year while decreases are taxable.

The neutrality features of an ACE regime are compelling when it comes to financing and investment decisions (Hall and Jorgenson 1967, King 1984, Devereux et al. 2002). Addressing investment and financing distortions through the introduction of an ACE regime has also been recommended by the famous Mirrlees review on reforming the tax system for the 21st century and repeatedly by the German Council of Economic Experts in the 2012 and 2015 editions of their annual economic report. Some countries introduced some variation of an ACE regime unilaterally (e.g. Belgium and Italy). The ACE in Belgium in particular triggered substantial revenue losses not only as a result of its narrowing of the tax base but also due to tax optimization schemes not being effectively targeted by anti-avoidance provisions (Zangari 2014). Consequently, many legislative measures (includ-

**Conventional Tax Systems Distort Financing Decisions**

### Assessing the ACE's Potential Impact Using Simulations

ing the introduction of a new tax) were taken to limit budgetary costs. While the average equity ratio increased, evidence on positive aggregate investment responses do not seem clear cut (Princen 2012; Valenduc 2011). The design of the ACE regime in Italy, by contrast, limits revenue losses by granting the allowance only on incremental equity and by implementing anti-avoidance rules targeting intra-group transactions.

Against the background of convincing theoretical arguments coupled with revenue concerns, several studies have assessed the ACE's potential impact using simulations.

Spengel et al. (2015) analyze the impact of different systems on the removal of debt bias regarding the cost of capital as well as effective marginal and effective average tax rates within the Devereux/Griffith (1999) framework. On average, in the EU the difference between the cost of capital for equity-financed investments as opposed to debt-financed investments amounts to 2.1 percentage points. This indicates a tax advantage for debt-financed investments. By granting a deduction for equity-financing, the cost of capital of equity-financed investments decreases. The AGI thus improves financing neutrality of corporate taxation. Nonetheless, the study also puts emphasis on the fact that perfect financing neutrality is not achieved when the notional interest rate differs from the relevant market interest rate. Moreover, under a revenue-neutral scenario, the Corporate Income Tax is shown to increase by 4.5 to 10 percentage points to compensate for the narrower tax base.

In a microsimulation study, Finke et al. (2014) provide an ex-ante analysis of an ACE tax regime in comparison with the German tax system of 2012. Taking behavioural responses into account, the study shows that the ACE regime with a profit tax rate increased by 6 percentage points triggered intensified outward profit-shifting activities and had a negative effect on location choices. In the long run, the tax revenue declines to about 88% of its original level. Since past reforms have shown that revenue neutrality is highly relevant for the policy-making process, this result points to a major obstacle to broad political approval of ACE. Sensitivity analysis shows, however, that revenue losses can be reduced substantially if the ACE deduction is determined for the incremental change in equity only. The current AGI proposal envisages such an incremental design.

Applying an international general equilibrium model (CORTAX), De Mooij and Devereux (2011) study the trade-offs in ACE and CBIT tax regimes for Europe. They find that the ACE regime is welfare-improving in all countries when tax rates are held constant. The ACE regime becomes welfare-reducing, however, when profit taxes are raised by 17 percentage points to offset the narrower tax base. A particularly noteworthy finding is that the coordinated introduction of the ACE reduces fiscal spillovers from tax rate competition, mitigating the negative effects of financing an ACE regime through raised profit tax rates.

To sum up, including an ACE type of regulation in the rules for a CCTB has advantages and disadvantages. It is certainly a systematic way to remove the debt bias and, as de Mooij and Devereux (2011) show, the coordinated introduction to some extent mitigates the concern that an ACE might be incompatible with international tax competition (Bond 2000). Still, the ACE regime introduces a revenue loss, putting pressure on the Member States to finance this loss. It also has repercussions for personal income taxation as a consistent implementation would require the ACE to be made available to partnerships and private savers. It also requires interest and dividends to be taxed in the same way.

Against this backdrop, incorporating an ACE element into the CCTB proposal might create additional tensions when it comes to finding political consensus on the CCTB due to the substantial revenue losses. In addition, as shown by the Belgium case, a system for neutrality financing can be exploited as a tax avoidance instrument in a cross-border setting (Hebous and Ruf 2015, Zangari 2014). Hence, special attention should be paid to defining regulations to address the misuse of AGI in cross-border tax avoidance schemes.

Alternatively, the Member States can eliminate tax distortions in financing decisions outside the scope of the CCTB by reforming shareholder taxation along the lines of a dual income tax (Sørensen 2005). This regime has also been put forward as a reform proposal by the German Council of Economic Experts, the MPI and ZEW (2006).

## 4 The Second Stage: The Impact of a CCCTB

The second stage of the CCCTB proposal (COM (2016) 683) provides for a switch from the taxation of separate entities to unitary taxation, reflecting the growing relevance of multinational companies. Consolidating profits at a group level and attributing the tax base to the subsidiaries' countries of residence by a predefined formula removes the incentive for profit shifting within the EU. In addition, transfer pricing documentation, which eats up a fair deal of resources in businesses and fiscal administrations, would be obsolete within the EU under the CCCTB. According to the impact assessment conducted by the Joint Research Centre of the European Commission, the CCCTB will increase investment by 3.4% and employment rates by 0.6% (COM (2016) 683, SWD (2016) 341). Despite existing empirical and theoretical evidence that firms might react to formula apportionment by re-allocating real production factors (e.g. Riedel 2010, Goolsbee and Maydew 2000, Nielsen et al. 2010), the study concludes that tax planning through factor shifting can be expected to be limited as non-tax arguments are thought to determine these choices. As the economic impact of the CCCTB is likely to depend on the tax responsiveness of the apportionment factors, it thus seems worthwhile to assess this issue more explicitly when preparing for the introduction of the second stage. In addition, the European Commission clearly recommends that the formula should better align taxation with economic activity. Yet, intangible assets – important drivers of multinationals' value creation – are not part of the formula. Excluding intangibles avoids the difficult task of measuring intangibles, which makes it difficult to determine appropriate transfer prices. However, this is also likely to induce a further redistribution of revenue away from knowledge economies. Finally, the current proposal refers to a one-stop-shop solution where the parent company (principal taxpayer) is accountable to one single tax administration in the parent's residence country. Consequently, additional focus should be on ensuring the same standards of tax administration and tax enforcement in all Member States. If enforcement is weaker in some Member States than in others, be it strategically or due to a personnel shortage, there is an incentive to locate a group's principal taxpayer in that jurisdiction.

**Removing Incentives for Profit Shifting within the EU**

## 5 Conclusion

By relaunching the CCCTB proposal, the EU Commission underscores its ambitions to fundamentally reform corporate taxation in the EU to address major shortcomings in today's corporate tax systems. In view of the existing evidence on the effects of CCTB and CCCTB and the expected challenges of reaching a political consensus, favouring the CCTB as a first step is reasonable. The regulations defining the CCTB as put forward in the proposal for a Council Directive provide a carefully prepared framework for harmonizing corporate taxable income and its rules are generally in line with country practice. Simulations for the 2011 proposal show that the expected changes in tax burdens following the introduction of a CCTB can be expected to be moderate for most countries. The regulations addressing cross-border profit shifting are also very much in line with current country practice. The newly introduced elements such as the AGI, an R&D super-deduction and a temporary cross-border loss relief regime, however, narrow the tax base. Although these elements may improve

**EU Commission Aims for a Fundamental Reform of Corporate Taxation**

the efficiency of tax systems in the EU, existing studies show that revenue losses might be substantial and might need to be financed by tax increases. Tax increases, in return, have negative implications for the EU's position in worldwide tax competition. Moreover, the introduction of an AGI is not convincing for two reasons: Firstly, the corporate debt bias should not be addressed at the corporate level (since such a step will interfere with Member States' tax autonomy at the level of personal income tax) but rather at the level of personal income tax (since here, Member States can decide on their own). Secondly, the AGI as proposed by the Commission has some shortcomings in terms of its theoretical design, which need to be clarified.

Including profit consolidation and formula apportionment in a second stage eliminates profit shifting within the EU. At the same time, there is evidence that this will potentially lead to new discretion for tax planning in particular with respect to factor allocation thus affecting real economic activities in the Member States.

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Zentrum für Europäische  
Wirtschaftsforschung GmbH  
Centre for European  
Economic Research

#### ZEW policy brief series

**Publisher:** Centre for European Economic Research (ZEW), Mannheim  
L 7, 1 · 68161 Mannheim · P.O. Box 10 34 43 · 68034 Mannheim · Germany · Internet: www.zew.de · www.zew.eu  
President: Prof. Achim Wambach, PhD · Director of Business and Administration: Thomas Kohl

**Editorial responsibility:** Prof. Achim Wambach, PhD

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