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# ATOZ ALERT

## Directive Proposal on BEFIT: A real necessity or just another layer of useless complexity?

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On 12 September, the EU Commission adopted a key package of initiatives containing notably a Directive Proposal on Business in Europe: Framework for Income Taxation ("**BEFIT**"). BEFIT is one of the initiatives announced by the European Commission in its May 2021 communication on Business Taxation for the 21st Century and aims to "*introduce a common set of rules for EU companies to calculate their taxable base while ensuring a more effective allocation of profits between EU countries, based on a formula*".

The Directive Proposal on BEFIT replaces and thus repeals the EU Commission's proposal for a common corporate tax base ("**CCTB**") and the proposal for a common consolidated corporate tax base ("**CCCTB**") that have never reached consensus.

In this article, we will analyse the Directive Proposal on BEFIT and comment on its implications.

### BEFIT scope

The Directive Proposal on BEFIT establishes a common set of rules to determine the tax base of companies subject to corporate income taxation in a Member State that are part of groups which prepare consolidated financial statements.

The BEFIT rules would be mandatory:

- for companies[1] resident for tax purposes[2] in a Member State, including their permanent establishments[3] located in other Member States, and
- for permanent establishments[4] located in Member States of entities resident for tax purposes in a third country ("**third-country entities**"),

if they belong to a domestic group or to a multinational enterprise group ("**MNE group**") which prepares consolidated financial statements[5] and had annual combined revenues of EUR 750 million or more in at least two of the last four fiscal years. In addition, the ultimate parent entity ("**UPE**") of the group shall hold at least 75% of the ownership rights or of the rights giving entitlement to profit of the in-scope entities.

While the mandatory scope of BEFIT comprises similar groups to Pillar 2 (i.e. groups with annual combined revenues of at least EUR 750 million), it would be limited to the so-called "BEFIT group members" (i.e. the EU sub-set group of entities that meets a 75% ownership threshold, assessed on a yearly basis).

The Directive Proposal on BEFIT provides specific rules for the computation of the EUR 750 million threshold in the case of M&A transactions or if one or more of the four fiscal years referred to is longer or shorter than 12 months.

This Directive Proposal on BEFIT shall not apply to companies or permanent establishments with a UPE outside the EU where the combined revenues of the group in the EU either do not exceed 5% of the total revenues for the group based on its consolidated financial statements or the amount of EUR 50 million in at least two of the last four fiscal years. Non-EU MNE groups having limited anchorage in the EU are thus out of scope of the Directive Proposal on BEFIT.

The BEFIT rules will be discretionary for smaller groups or companies or permanent establishments with a UPE outside the EU which are out of the mandatory scope of application, which may choose to opt in as long as they prepare consolidated financial statements.

The Directive Proposal on BEFIT does not contain sector-specific exclusions from its scope. However, as the BEFIT proposal only targets entities that are subject to corporate tax, referring to corporate income tax as far as Luxembourg is concerned, we can already conclude that Luxembourg investment funds subject to subscription tax will be out of the scope of BEFIT (but could be in the scope of Pillar 2).

## BEFIT mechanism

### COMPUTATION OF BEFIT GROUP MEMBERS' TAX BASES IN ACCORDANCE WITH A COMMON SET OF RULES.

Under the Directive Proposal on BEFIT, BEFIT group members would need to calculate their tax base in accordance with a common set of rules. Like in Pillar 2, the starting point will be the accounting result from the financial accounts, which must be determined under one single accounting standard for the BEFIT group. To this

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[1] Taking one of the forms listed in Annex I: companies under Luxembourgish law known as 'société anonyme', 'société en commandite par actions', 'société à responsabilité limitée', 'société coopérative', 'société coopérative organisée comme une société anonyme', 'association d'assurances mutuelles', 'association d'épargne-pension', 'entreprise de nature commerciale, industrielle ou minière de l'Etat, des communes, des syndicats de communes, des établissements publics et des autres personnes morales de droit public', and other companies constituted under Luxembourg law subject to Luxembourg corporate tax.

[2] It means that they are subject to one of the corporate taxes listed in Annex II, or to a similar tax subsequently introduced - "impôt sur le revenu des collectivités" in Luxembourg.

[3] When they are subject to one of the corporate taxes listed in Annex II or to a similar tax subsequently introduced - "impôt sur le revenu des collectivités" in Luxembourg.

[4] When they are subject to one of the corporate taxes listed in Annex II or to a similar tax subsequently introduced - "impôt sur le revenu des collectivités" in Luxembourg.

[5] In respect of companies, they are the ultimate parent entity ("UPE") or their assets, liabilities, income, expenses, and cash flows shall be consolidated on a line-by-line basis by the UPE. In respect of permanent establishments, they are a permanent establishment of the UPE or of an entity whose assets, liabilities, income, expenses and cash flows shall be consolidated on a line-by-line basis by the UPE.

aim, the financial accounts of each BEFIT group member will have to be reconciled, in principle, with the accounting standard of the UPE.

For simplification purposes, adjustments under BEFIT would be kept to a minimum, rather than putting together a detailed corporate tax framework. In case they are deducted or not already recorded in the financial accounting statements, BEFIT adjustments would require **the following items to be added back**:

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

On the contrary**, the following elements would be subtracted** from the financial net income or loss if they are in the financial accounts:

- dividends and capital gains or losses on shares or ownership interests, in the case of significant ownership (at least 10% of the profits, capital, reserves or voting rights and held for more than one year) and unless they are held for trading or by a life insurance undertaking;
- the profit or losses from permanent establishments;
- shipping income subject to a national tonnage tax regime;
- rollover relief for gains on assets that are replaced;
- acquisition, construction and improvement costs of depreciable assets, because these costs will already be part of the depreciation base, as well as subsidies directly linked to this, because subsidies should neither be in the depreciation nor tax base;
- unrealised gains or losses from currency exchange fluctuations on fixed assets;
- any amount relating to the post-allocation adjustments listed by the Directive proposal on BEFIT; and
- fixed tangible assets valued below EUR 5 000 (to be excluded in the fiscal year of acquisition only).

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

The Directive Proposal also provides for BEFIT tax depreciation rules for fixed assets and so-called “Timing and Quantification rules” in order to avoid abuses (e.g. provisions are excluded if they are not legally required or cannot be reliably estimated; bad debts can only be deducted under certain conditions and never if the debtor is an associated enterprise; the treatment of hedging instruments must follow the tax treatment of the hedged item).

Finally, the Directive Proposal includes rules that would apply in case of entities entering or leaving the BEFIT group and business reorganisations (to clarify for example that the Merger Directive takes precedence).

There is also an anti-abuse rule that would ensure that capital gains on assets are included in the preliminary tax result when the assets are moved within the group, without tax implications, to a group member which is then sold out of the group. This would normally benefit from a tax exemption for share disposals but would not be allowed under BEFIT, unless it can be justified from a commercial perspective.

**AGGREGATION OF THE BEFIT GROUP MEMBERS’ TAX BASES INTO ONE SINGLE TAX BASE.**

The preliminary tax results of all BEFIT group members will be aggregated into a single “pool” at EU group level, which will be the “**BEFIT tax base**”.

When the BEFIT tax base in a given year is a positive amount, the profit would be allocated to the BEFIT group members according to an allocation key.

In case the BEFIT tax base in a given year is a negative amount, the loss would be carried forward and may offset against the next positive BEFIT tax base at EU group level.

The aggregation of the preliminary tax results of all BEFIT group members to obtain the BEFIT tax base would have the following consequences:

- Cross-border loss relief allowing the BEFIT groups to set off losses across borders.
- No withholding taxes on transactions such as interest and royalty payments within the BEFIT group, as long as the beneficial owner of the payment is a BEFIT group member: BEFIT does not, however, define the concept of beneficial owner (which would likely result in significant legal uncertainty).
- Certain transfer pricing simplifications: the arm's length principle would be replaced by formulary apportionment (even though transactions would still need to adhere to the arm's length standard). The arm's length principle would only be relevant for transactions with non-EU members of the group.

Such consequences would lead to a drastic change of the corporate tax system which would obviously raise concerns with respect to public finances as it seems to be impossible to predict the exact impact on the budget of EU Member States. Most likely, corporate tax revenues would change significantly, be it to the upside or the downside.

**ALLOCATION OF THE AGGREGATED "BEFIT TAX BASE" TO EACH MEMBER OF THE BEFIT GROUP.**

Once the BEFIT tax base is determined, the aggregated tax base corresponding to a positive amount would be allocated to each member of the BEFIT group based on a transition allocation rule according to which each member of the BEFIT group would have a percentage of the aggregated tax base calculated on the basis of the average of the taxable results in the previous three fiscal years. This would be meant to pave the way for a permanent allocation method that could be based on a formulary apportionment.

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

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

According to the EU Commission, the transitional allocation rule should "*pave the way for a permanent allocation method that can be based on a formulary apportionment using substantive factors. In designing a permanent allocation method, the transitional solution will make it possible to take into account more recent County-by-Country Reporting (CbCR) data and information gathered from the first years of the application of BEFIT. It will also allow for a more thorough assessment of the impact that the implementation of the OECD/G20 Inclusive Framework Two-Pillar Approach is expected to have on national and BEFIT tax bases*". In addition, the Commission announced that, if appropriate, it may propose a Directive whereby the aggregated tax base will be allocated based on a factor-based formula.

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

Finally, to ensure Member States' competence in tax rate policies, the Directive Proposal on BEFIT also allows Member States to introduce further deductions, tax incentives, or base increases, to the extent these comply with the EU Directive on Minimum Tax/Pillar 2.

## Critical review

The BEFIT initiative raises a number of concerns:

- **Complexity**: BEFIT aims to replace the current 27 national corporate tax systems for MNE groups. As a result, Member States would be required to administer two comprehensive sets of corporate tax rules in parallel (i.e. BEFIT and their national rules - which will include Pillar 2 rules). This would increase complexity, administrative burden and related costs (on the part of the taxpayer and the tax administrations). Hence, the purported objective of the BEFIT initiative (i.e. reducing the tax compliance burden for EU businesses) may not be achieved. In addition, the Pillar 1 initiative would further increase complexity.
- **Assault on national sovereignty**: The adoption of the Directive Proposal on BEFIT would undermine national sovereignty over tax matters through the backdoor as it would largely replace domestic tax laws with an EU corporate tax system over which individual Member States would have extremely limited control. Taking into consideration the fact that the corporate tax laws of EU Member States are already largely similar (following the implementation of ATAD1, ATAD2, DAC6, Pillar 2, etc.) and tax authorities of EU Member States have a comprehensive arsenal of anti-abuse rules that allow them to tackle any kind of abusive situation (as well as reporting requirements that allow them to be aware of any residual abuse), and the recent adoption of the Pillar 2 Directive that aims to implement a jurisdictional minimum taxation of at least 15% computed on a common tax basis, the need for the BEFIT initiative is, at the very least, questionable.
- **Unprecedented legal uncertainty for businesses**: The implementation of BEFIT would further result in years (likely more than a decade) of legal uncertainty, that would come on top of the significant legal uncertainty existing already because of the numerous tax law changes over the last years (ATAD1, ATAD2, DAC6, Pillar 2, etc.). Replacing domestic tax systems by a new set of rules that might be interpreted differently in EU Member States would be an adventure for taxpayers and EU Member States alike. Considering that it may take up to ten years until the Court of Justice of the European Union ("**CJEU**") takes a decision (a case must go through the courts of the Member State before it can be referred to the CJEU), it would take a very long time before the new rules would be settled.
- **Unintentional incentives for businesses**: It should further not be forgotten that such a fundamental change of the corporate tax system may create unintended incentives for multinational groups that may reduce their economic activity in some Member States or in the European Union altogether. For example, multinational groups might consider shifting shared service centres and production to jurisdictions with low salary costs or reduce activities in the EU to benefit from the de-minimis rule.

## Next steps and conclusion

The previous experience with proposals of the EU Commission that aimed at a complete harmonisation of corporate income taxation rules (i.e. CCTB and CCCTB) showed that it might be difficult to convince all EU Member States of the necessity of such initiative.

While governments may be driven by their own interests (e.g., increasing tax revenues or receiving transfer payments from the EU), not all EU Member States would gain with BEFIT, and it may even be difficult to tell which EU Member State could benefit (plus the uncertainty associated with a future adoption of a factor-based formula). The coexistence of BEFIT with the rules for a global minimum taxation (Pillar 2) would further increase complexity and legal uncertainty.

The EU Commission believes that a consensus could be achieved because the proposal is built on the OECD/G20 Inclusive Framework on BEPS (in developing a two-pillar solution) and the related Pillar 2 Directive providing for a global minimum taxation. However, it should be noted that unanimity is required for the adoption of the Proposal Directive on BEFIT at the European Council level. In addition, as this proposal effectively undermines national sovereignty (which is not the case for the Pillar 2 Directive), the full harmonisation of corporate tax rules at EU level may prove to be a difficult undertaking.

Should the Directive Proposal on BEFIT be adopted by the Council, it would enter into force on 1 July 2028. Time will tell if this becomes a reality.

## Do you have further questions?


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