Taxing Multinationals in Europe

Wolfgang Schön
Max Planck Institute for Tax Law and Public Finance
University of Melbourne
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Taxing Multinationals in Europe

- Fundamental Issues of Group Taxation:
  - *Intercompany Dividends*
  - *Financing Costs for Subsidiaries*
  - *CFC-Legislation*
  - *Intra-Group Loans*
  - *Transfer Pricing for Intra-Group Supplies and Services*
  - *Group Relief for Losses of a Group Member*

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- Requirements of the Internal Market:

- Equal treatment for cross-border establishment (PEs and subsidiaries) with domestic situation unless overriding public interest justifies discrimination (Art.49 TFEU).
- Equal treatment for cross-border movement of capital (portfolio shares and bonds) under the same circumstances (Art.63 TFEU).
- Parent-Subsidiary Directive and Interest-Royalty Directive have scrapped witholding taxation for cross-border groups.

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- Overriding public interest accepted by the ECJ:
  - NOT Loss of revenue
  - NOT Protection of local business
  - BUT Fight against tax avoidance („artificial arrangements“)
  - BUT Balanced allocation of taxing Powers (highly disputed concept)
  - BUT coherence of the domestic tax system (rarely applied)

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- *Intercompany Dividends*

- Most countries have introduced imputation or exemption rules for intercompany dividends, partially limited to „substantial“ participations.
- Parent-Subsidiary Directive provides for abolition of withholding tax on cross-border intercompany dividends and exemption or credit of the underlying CIT for participations ≥ 10 %

- What about participations < 10 %?

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- *Intercompany Dividends*

- ECJ: The residence country of the parent company is obliged to extend all benefits for domestic participations to foreign participations (imputation and exemption).
- ECJ: The source country is obliged to extend the tax-free status of domestic dividends in the hands of domestic parent companies to the withholding tax on outflowing dividends.
- Thus, the decision to do away with double-layer taxation for domestic groups transforms into a waiver of taxing rights on international groups. Countries face an incentive to re-introduce double taxation on local groups.

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- *Financing Costs for Subsidiaries*

  - Parent Subsidiary Directive grants discretion to the Member States whether to make financing costs for foreign subsidiaries deductible (including an option to apply a 5 % rule).
  - ECJ: Whenever Member States declare financing costs on domestic subsidiaries to be deductible at the level of the parent company this treatment has to be extended to financing costs for foreign subsidiaries.
  - ECJ: The „territoriality principle“ does not justify this unequal treatment. Judgments were rendered before the concept of „balanced allocation of taxing powers.

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- *Financing Costs for Subsidiaries*
  - Profit derived by subsidiary will only be taxed at the level of the subsidiary. Dividends paid to the parent company are tax exempt under the Parent Subsidiary Direcitve.
  - Costs will be fully deductible at the level of the Parent Company unless its state of residence scraps deductibility for domestic subsidiaries as well.
  - Member States move to non-discriminatory „debt cap“ and „interest cap“ provisions in order to press companies to allocate equity and debt proportionally across corporate groups.

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- *CFC Legislation*

- Treatment of subsidiaries in low-tax countries deriving „passive“ income which is either retained or exempt when dividends are paid out? The concept of capital export neutrality presses for attribution of that income to the parent company.
- ECJ: CFC legislation discriminates against foreign subsidiaries. Tax-driven cross-border establishment is protected by Internal Market. Only „artificial arrangements“ lack this protection. Taxpayer must be able to show economic substance.

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- *CFC Legislation*

- Effect: CFC legislation is largely reduced to fight blatantly abusive cases. Individual tests on economic substance and „motives“ are spreading.
- Alternative: Transform CFC legislation into CC legislation, doing away with the „foreign company“ criterion.

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- *Intra-Group Loans*

- Member States have an interest in taxing income generated within their territory.
- Interest-Royalty Directive (2003) prohibits withholding tax on intra-group interest payments.
- Many countries had introduced „thin cap“ legislation in order to ensure taxation of outflowing interest payments.
- ECJ (2002) has declared this to be incompatible with the Internal Market. Only „artificial arrangements“ (= non-arm‘s length loans) can be disqualified (2007).

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- *Intra-Group Loans*

- Effect: Thin capitalisation has to be accepted if
  - the loan meets the arm‘s length standard or
  - the taxpayer can show commercial reasons for non arm‘s length loan (debt work-out etc.)

  Member States have resorted to introducing „debt cap“ or „interest cap“ provisions which press companies to establish group-wide proportional allocation of debt and equity.

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- *Transfer Pricing Control*

- Transfer pricing rules around the world apply the arm‘s-length standard to cross-border intra-group transactions. This goes regularly beyond the control exercised with respect to domestic group transactions. It is meant to ensure equal tax treatment for independent and dependent companies.
- ECJ (2010): The arm‘s length standard is in line with the right of Member States to fight „artificial arrangements“. But the taxpayer is entitled to show commercial reasons for non-arm‘s length transactions.

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- *Transfer Pricing Control*

- Given the fact that the „economics of the firm“ are not identical with the economics of the open market I expect a wide range of possible justifications for non-arm‘s length pricing.
- Member States have already started to introduce identical arm‘s length control provisions for domestic groups.
- Countries should consider alternative methods of taxing rights allocation which do not simply follow allocation of the tax base to companies.

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- *Cross-Border Loss Compensation*

- Many countries provide for group-wide loss compensation. Prominent examples are „group relief“ (UK), „group contribution“ (Scandinavia), „consolidation“ (Netherlands) and „Organschaft“ (Germany).
- Most countries do not accept foreign losses (from subsidiaries or PEs) to be set off against domestic profits of another group company.
- ECJ: This is in line with the necessity to ensure a „balanced allocation of taxing powers“ between Member States. But „final losses“ which cannot be used in the source country have to be set off in the residence country under the same conditions as for domestic losses.

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- *Cross-Border Loss Compensation*

- Effect: Awkward compromise which makes tax treatment in state of residence dependent on tax treatment in state of source.
- Effect: Cross-border investment is severely disadvantaged. Elegant solution („recapture“ of foreign losses once profits are made in the source country) has not been supported by the ECJ.

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- Intermediate Conclusion:
  - The ECJ basically puts domestic groups and cross-border groups on the same footing.
  - Justification for unequal treatment is largely reduced to the fight against „artificial arrangements“.
  - Member States face the alternative of either putting an extra burden on domestic business or to reduce their revenue in cross-border situations.
  - Loss compensation stands out as an example for a beginning compartmentalization of taxing rights in Europe.

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- Is the CCCTB the answer?

  - Draft Directive (March 2011)
  - Full Consolidation of Group Results
  - Tax Base Allocation under Formula Apportionment (Assets, Payroll, Sales)
  - Joint Administration

What are the effects on the described problems?

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- Effect of the CCCTB on Taxation of MNEs in Europe:

- Intercompany dividends are simply non taxable under consolidation.
- Deductibility of financing costs is fully recognised. But the contractual allocation to the parent or to the subsidiary is irrelevant. It follows the sharing mechanism where financial liabilities do not affect the formula.
- CFC legislation becoms unnecessary as the location of pure financial assets doesn‘t matter under the formula.

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- Effect of the CCCTB on Taxation of MNEs in Europe:

- Thin cap rules become unnecessary as intra-group loans are disregarded anyway. Financial assets and liabilities are not part of the formula.
- Transfer pricing rules become partially unnecessary as intra-group transactions are consolidated anyway.
- Cross-border loss compensation comes as a natural element of cross-border consolidation of group profit.

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- BUT: The CCCTB is an „optional instrument“ for the multinationals. They can choose the best of both worlds.
- BUT: Not all EU countries are willing to join the CCCTB area. Therefore the establishment of subsidiaries in EU Member States outside the CCCTB area will provide groups with full entitlements under the current system.
- BUT: Multinationals extend beyond the boundaries of the EU. Subsidiaries in third countries will allow them to make use of the existing framework (without specific protection under the rules of the Internal Market).

THANK YOU!