The Effect of Corporate Tax Base Harmonization in the EU

The European Commission (EC) has renewed its proposals on the Common Consolidated Corporate Tax Base (CCCTB) initiative. The initiative refers to two proposals by the European Commission for an EU-wide tax code aimed at companies operating in more than one Member State. Under CCCTB, businesses would compute their annual EU taxable income and apportion shares of it to different Member States according to a set formula, taking into account revenue, employee numbers, wages and assets. Under CCCTB, each Member State would apply national tax rates on profits of its companies. The renewed proposal introduces a two-step approach: efforts will first concentrate on compiling the rules for the Common Corporate Tax Base (CCTB), and consolidation (CCCTB) will be left for a later stage. According to the EC, Member States will have to transpose the CCTB directive into their national laws by 31 December 2018 and CCCTB directive by 31 December 2020.

Proponents of corporate tax harmonisation claim that the proposal will:
- create a better integrated market and secure free trade by removing tax obstacles;
- promote sustainable growth and investment;
- make the EU tax system easier to comply with;
- alleviate the burden of tax administration (both for taxpayers and tax administrators);
- guarantee even competition conditions;
- safeguard national tax revenues;
- improve tax transparency; and
- reduce tax avoidance (profit shifting, double non-taxation) and aggressive tax planning opportunities.

There are multiple reasons to suggest though that CCCTB is not the best tool to achieve these objectives.

Complete tax harmonization would destroy tax competition between countries, and this would have adverse effects.

Unified tax rules can hardly contribute to trade liberalisation. A diversity of tax systems is not a roadblock for free trade. Quite the opposite, differences in tax systems might serve as a stimulus to trade. Taxes constitute a significant share of costs and a large share of the price of factors of production, labour in particular. It is tax diversity (which is usually determined by the necessity to accommodate to local conditions and traditions) that frequently provides opportunities to produce cheaper goods and services and to offer them on the international market. Thus, absence of centralised tax harmonisation encourages beneficial trade rather than undermining it.

Countries have always competed using their exogenous factors (e.g. the amount of land, population, proximity to waterways, etc.) as well as endogenous one (e.g. the level of corruption, political stability, the level of bureaucracy and taxation). Competition by endogenous factors (e.g. taxation) should not be perceived as “unfair” or “unnatural.” Tax competition is no different than competing for investment by cutting red tape, lowering bureaucracy and other factors that depend on national governments.

CCCTB confuses value-added with inputs.

The current proposal on CCCTB for harmonization of the tax base and profit tax share is based on a calculation formula which takes into account revenue, employee numbers and wages as well as most assets. By trying to reduce tax avoidance CCCTB could be interfering directly with modern production and distribution practices. In determining the "true" location of economic activity (and in which country to pay the tax) CCCTB incorrectly equates value added with inputs (labor, wages or real estate). CCCTB does not account for modern practices where the value of a product is created by branding, brand names and other subjective factors.

CCCTB will prevent market agents from selecting better taxation options.

Under CCCTB companies will not be able to exploit the advantages of different tariffs in different Member States. The introduction of CCTB would have a considerable impact on the values of the tax base in the EU Member States, except for Cyprus and Ireland, the values of the tax base would increase in all countries. On average, the effective tax burden would increase by 5.15% [1] and the common tax base would be expanded by 7.9 %. [2] In particular, the business environment would deteriorate in Estonia which currently applies its corporate tax on paid out dividends. So the proposed policy will not help businesses. Business needs good business conditions, not uniform taxes.

Rules on the depreciation of fixed assets would be extremely harmful for Lithuanian companies.

According to the CCTB proposal, fixed assets are defined as (1) tangible assets acquired for value or created by the taxpayer and (2) as intangible assets acquired for value that are capable of being valued independently and that are used in the business for producing, maintaining or securing income for more than 12 months, except where their acquisition or construction cost is less than EUR 1,000.

Currently Lithuania applies the same rule of usage for more than 12 months, but fixed assets are treated as such when their acquisition price is not less than the minimum purchase price for the group of assets set by the taxpayer. This rule allows more flexibility for the taxpayer to determine which goods are treated as fixed assets.

The CCTB proposal determines the useful life of fixed assets as follows:

<table>
<tr><td>Asset type</td><td>Useful life</td><td>Useful life (current situation in Lithuania)</td></tr>
<tr><td>Commercial, office and other buildings, as well as any other type of immovable property in use for the business, with the exception of industrial buildings and structures</td><td>40 years</td><td rowspan="2">(a) new buildings used in commercial activities and buildings included in the Lithuanian register of cultural properties, reconstruction of the buildings built or reconstruction carried out since 1 January 2002: 8 years;
(b) residential buildings: 20 years;
(c) other buildings: 15 years</td></tr>
<tr><td>Industrial buildings and structures</td><td>25 years</td></tr>
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<tr><td>Long-life fixed tangible assets not listed above</td><td>15 years</td><td rowspan="2">(d) machinery and equipment: 5 years;
(e) devices (structures, wells, etc.): 8 years;
(f) electricity transmission and communication devices (except for computer networks): 8 years;
(g) railway rolling stock (locomotives, wagons, tanks), vessels: 8 years;
(h) pipelines, planes, weapons: 15 years;
(i) furniture: 6 years;
(j) computer hardware and communication equipment (computers, networks and software): 3 years;
(k) cars: from 4 to 10 years;
(l) vehicles, trailers and semi-trailers: 4 years;
(m) other tangible assets not listed above: 4 years;</td></tr>
<tr><td>Medium-life fixed tangible assets</td><td>8 years</td></tr>
<tr><td>Fixed intangible assets: the period for which the asset enjoys legal protection or for which the right has been granted or, where that period cannot be determined</td><td>15 years</td><td>(n) other intangible assets: 4 years;
(o) goodwill: 15 years.</td></tr>
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Under the CCTB proposal, the same depreciation rules apply to second-hand items, unless the taxpayer demonstrates that the estimated remaining useful life of the asset is shorter than stated years, in which case it shall be depreciated over that shorter period. Other fixed assets shall be depreciated together in one asset pool at an annual rate of 25 % of the depreciation base. Fixed tangible assets not subject to wear and tear and obsolescence such as land, fine art, antiques, or jewellery and financial assets will not be subject to depreciation.

In Lithuania, if used in R&D activities, devices (structures, wells, etc.), machinery and equipment, computer hardware and communication equipment (computers, networks and software) and other not listed tangible and intangible assets may be depreciated in two years.

This means that in Lithuania the terms of depreciation are considerably shorter than those proposed by the EC. The adoption of CCTB would harm Lithuanian business conditions as for most categories of assets depreciation would be extended more than twice. New rules would lead to disproportionately and artificially expand the CIT base.

R&D super-deduction may not bring anticipated results.

Provisions such as super-deductions tend to mostly benefit companies that are profitable, which is not always the position that many companies investing in R&D find themselves in, especially in a start-up situation. Under the CCTB proposal, R&D costs will be fully expensed in the year incurred (with the exception of immovable property). In addition, taxpayers will be entitled to a yearly extra super-deduction of 50% for R&D expenditure up to EUR 20 000 000. To the extent that R&D expenditure reaches beyond EUR 20,000,000, taxpayers may deduct 25% of the exceeding amount.

This enhanced super-deduction will be introduced for small starting companies without associated enterprises which are particularly innovative (a category that will in particular cover start-ups). In that context, eligible taxpayers may deduct 100% of their R&D costs in so far as these do not exceed EUR 20,000,000 and provided that these taxpayers do not have any associated enterprises.

Although super-deductions would be a positive step, only a small part of businesses would benefit from them. The reason is very strict R&D criteria. For example, a company willing to use an enhanced super-deduction must have fewer than 50 employees and annual turnover and/or annual balance sheet not exceeding EUR 10,000,000. It also must not be registered for longer than 5 years and have any associated enterprises. R&D activities are also strictly defined.

Currently Lithuania has even more generous R&D super-deduction: for the purpose of the calculation of the corporate income tax, R&D costs can be deducted three times from income for the tax period in which they are incurred.

Another corporate income tax benefit is available to businesses investing in technological modernisation. This benefit gives businesses the right to reduce their estimated taxable profit by up to 50 percent. Taxable profit can be reduced by the amount invested in technological modernisation. Investment costs in excess of 50 percent of estimated taxable profit can be carried forward and the taxable profit can be reduced in subsequent tax periods (the costs can be carried forward for four consecutive tax periods).[1] Together with abovementioned super-accelerated depreciation Lithuania offers R&D a favourable business environment.
The CCTB proposal, if adopted, would worse these conditions.

Instead of introducing the proposed measures, the EC should apply the most investment favourable regime. For example, Estonia, which applies the corporate income tax only on redistributed profits, has the largest share of gross domestic expenditure on R&D, (% of GDP), compared to other countries in the region (Latvia and Poland).

If imposed on all companies, CCCTB would make tax compliance harder.

If unified tax rules were imposed on all EU companies, companies operating only on the domestic (national) market would experience no tangible effects. At the same time businesses (especially SMEs) would also incur costs of conforming to the new rules. For example, a Lithuanian company selling goods only in Lithuania would have to bear compliance costs if in the future CCCTB replaced the current Lithuanian corporate tax base.

[1] http://www.investlithuania.com/news/corporate-income-tax-relief-offered-to-businesses-investing-in-innovation/

CCCTB might not reduce business and tax administration costs and could even increase them.

Although CCCTB may be advantageous for businesses as they will no longer need to scrutinise different rules of computing the corporate tax base, there is a high probability that a reduction of the administrative burden will be offset by an increase in other burdens (and costs). Also, differences between tax bases in various Member States may still remain as they are usually given some leeway even in the case of the strictest harmonisation.

According to a study by PwC, an introduction of CCTB in Lithuania would increase a company's internal costs by 14% and external costs by 6 %, while one-off costs associated with the introduction of CCTB would be approximately EUR 19,000. The projected growth of costs are generally associated with more complex regulations than the current tax rules.

An introduction of CCCTB would increase internal costs by 5% and reduce external costs by 22%, and one-off costs associated with the introduction of CCCTB would be the same as in the CCTB scenario (approximately EUR 19.000).

The introduction of both CCTB and CCCTB is likely to increase the administrative burden for the State Tax Inspectorate (STI). If CCTB becomes compulsory, the administrative burden will increase by 2 % or EUR 1.4 million *per annum* (over a 5-year period). If the CCTB is optional, the administrative burden will increase by 45% or EUR 2.7 million *per annum* (over a 5-year period). In case of compulsory CCCTB, the administrative burden will increase by 25% or EUR 1.5 million *per annum* (over a 5-year period). If the CCCTB is optional, the administrative burden will increase by 47% or EUR 2.9 million *per annum* (over a 5-year period). This increase is associated with the complexity of the CC(C)TB tax administration process, taking into account the existing expertise of STI and the need to administer two systems (national and CC(C)TB). [3]

In three scenarios (optional CC(C)TB and compulsory CCCTB) an increase in the administrative burden of STI would outweigh the expected corporate tax revenues.

Requirements to disclose sensitive information would put EU businesses at a competitive disadvantage.

Requirements to disclose more information about a company's tax affairs and other activities as would be required for the operation of CCCTB would also increase the likelihood of disclosure of trade secrets and confidential business information (such as information about tax management, revenues, revenues split between related and unrelated parties, profit or loss before tax, income tax paid and accrued, stated capital, accumulated earnings, tangible assets, public subsidies received, etc.). This policy would be harmful to EU companies as they would be placed at a competitive disadvantage vis-à-vis non-EU multinational companies not based in EU member-states but operating in the EU.

Conclusions

Harmonisation of the corporate tax base would not only fail to attain the desired goals but would also engender a number of negative consequences:

- Corporate tax harmonisation would create considerable compliance costs in the transition period, especially for SMEs operating within the market of only one Member State.
- Fiscal centralisation would undermine competitiveness of the entire region as a centralised tax system erected inside the region, would force companies to take opportunity of the competitive advantage outside the region's territory.
- In certain cases harmonisation of the corporate tax base may be advantageous to individual taxpayers or taxpayers in certain countries (by removing double taxation, reducing administrative costs of MNEs in a long term, etc.). However, this would not occur as a systematic reduction of the tax burden but rather as a side effect of tax harmonisation on individual taxpayers.

Recommendations

- The European Commission should work to preserve the highest degree of tax competition between Member States. The CC(C)TB poses the danger of fundamentally hindering this vital feature of the internal market and should therefore be reconsidered.
- If the CC(C)TB is retained, the European Commission should also ensure that the CC(C)TB remains optional and pre-empts future moves to damaging harmonisation.
- High-tax EU Member States advocating tax harmonisation should take practical steps towards harmonisation by aligning their tax systems with those tax regimes that are the most conducive to economic growth.

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[1] Christoph Spengel, Andreas Oestreicher et al., Centre for European Economic Research (ZEW), *Study on the impact of reforms of corporate income taxation systems at the EU level on the size of the tax bases of the EU companies, using the model "European Tax Analyzer"*, 2008, 150.
<http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/ccctb/eta.pdf>

[2] European Commission, *CCCTB: Questions and answers*, 2011, 7.
<*www*.europa.eu/rapid/press-release_MEMO-11-171_lt.doc>

[3] PwC, Bendros konsoliduotos pelno mokesčio bazės įtakos Lietuvai vertinimas, 2013.