Comments on document CCCTB\WP\040
Common Consolidated Corporate Tax Base Working Group
– Personal Scope of the CCCTB –

Introduction

In July 2006 the Commission issued a Working Paper dealing with the "personal scope" of the CCCTB. The paper focuses on the persons to be included in the scope of the CCCTB and thus eligible for CCCTB treatment. The UNICE Task Force on CCCTB is grateful to have the opportunity to express its view on this issue. As in previous comments, the positions taken may be subject to revision as other areas of the CCCTB are explored.

General remarks on the "personal scope"

The CCCTB needs to be competitive and attractive if it is to contribute to the achievement of the Lisbon objectives. We therefore agree with the Commission that the regime should be as widely applicable as possible with respect to the definition of eligible entities.

A wide application is essential in order to maximise the positive effects of the CCCTB. It is also important to keep the compliance costs of entering into the system to a minimum. Cross-border businesses are currently using a wide range of entity forms with various civil and tax law characteristics. If the CCCTB is to be successful, it is important that businesses can opt for CCCTB-treatment without having to go through costly reorganizations processes. By allowing for a broad application, the need for reorganization is kept to a minimum.

It is furthermore important to recall that the fundamental reason why countries provide for different entity types is to ensure *efficiency* by enabling the entrepreneur (i.e. the person carrying on the business) to choose a legal vehicle featuring the characteristics that best suits the relevant business activity. Thus, to uphold the objective of efficiency and to provide for neutrality in the choice between electing for CCCTB-treatment or continuously being taxed under current rules, it is again important that the CCCTB ensures a wide applicability.

On this basis, the general approach for defining eligible entities should be to identify what business vehicles to exclude rather than what business vehicles to include. An entity type should only be excluded where it is motivated by very convincing reasons.

Corporate tax nexus

The fundamental purpose of the CCCTB is to provide for a common tax base for *corporate income tax* purposes throughout the EU. That is, the aim is to create a common base on which the member states levies their corporate taxation. As has been underlined repeatedly, it is essential that the CCCTB materializes in a comprehensive corporate tax system which upon election replaces current domestic systems.

With this in mind, we believe that the CCCTB should cover all entities which trigger corporate income tax in their respective Member States. Conversely, activities carried out in entities which do not trigger corporate income tax should be excluded. This would promote clarity and simplicity and provide for a logical delimitation of the personal scope.

Moreover, a CCCTB that would include some "corporate entities" but not others would deviate from the objective of creating a common and comprehensive tax base for corporate tax purposes in the EU. The exclusion of certain entity types liable to corporate taxation would lead to situations where the CCCTB and current domestic tax rules have to be applied concurrently. This would defeat the very purpose of the CCCTB and provide for considerable complexity both for taxpayers and tax administration.

In its Working Paper, the Commission indicates that nevertheless there might be a need to exclude some entities subject to corporate tax either because they are not carrying on a business activity or because they are active in a specific business sector which call for a deviating treatment (shipping, the financial industry or central banks are put forward as examples).

With respect to the first issue we would like to repeat that the CCCTB must not be based on a "business purpose test". Such a subjective test would provide for harmful uncertainty and lead to complex evaluation processes both for business and for tax administrations. Instead, the CCCTB should be based on the presumption that an entity which is liable to corporate taxation is carrying on a business activity for CCCTB purposes.

As for the second issue, whether a company is active in a specific business sector should not interfere with the definition of an eligible entity type as such. The rules to determine the personal scope for CCCTB should in principle be applied to all business sectors alike.

As the rules to distinguish the personal scope of the CCCTB will determine the definition of an eligible entity type, the Commission should also consider here how permanent establishments or branches will be considered as they often bring similar tax consequences as if they were separate taxable entities subject to corporate income tax in their own rights.

Eligible entities etc.

Under the suggested "corporate tax nexus"-approach, there is a strong need to clarify two issues:

1. what is a corporate income tax and
2. what constitutes an entity liable for such a tax for CCCTB purposes (and thus is eligible for CCCTB-treatment)

The first issue does not appear to create any major difficulties. All Member States impose corporate income taxes of some sort and they are relatively easy to identify. To ensure certainty and predictability, however, the CCCTB should provide for a list where the various domestic taxes are clearly defined. Such lists already exist under domestic law in many Member States.

The second issue requires somewhat deeper analysis. In this respect the Commission correctly distinguishes between entities subject to tax as such (i.e. opaque entities) and entities not liable to tax as such (i.e. transparent entities). In addition, however, it is also important to recognize differences in the legal capacity under general law. Whereas some entity types have legal capacity (or personality) separate from its owners under general/corporate law, others do not.

Thus, looking at the legal characteristics of the various entity forms available in the Member States, they can (somewhat simplified) be assorted into either of four categories.

1. Legal entities which are opaque for tax purposes

This entity group has legal capacity separate from its owners both under general law and under tax law. That is, they feature both some level of separate legal personality under general law and are also subject to corporate income tax as such (i.e. opaque). The *limited liability company* is perhaps the most notable example of this entity type.

We clearly agree with this Commission that this entity type should be covered by the CCCTB. As the entity is liable to corporate income tax as such, it automatically corresponds with the "corporate tax nexus". It is also the most common entity form used by MNEs.

2. Legal entities which are transparent for tax purposes

This entity group features legal capacity separate from its owners under general law but not under tax law. Thus, although being a legal entity for general law purposes, it is transparent for tax purposes. This is commonly the case with respect to *partnerships*.

Based on the arguments of a wide application, we believe that transparent legal entities should be included in the CCCTB. Transparent entities, such as partnerships, are very commonly used in current business structures and the exclusion of this entity type would frequently require difficult and costly reorganizations to allow for a common CCCTB-treatment. Also, for the efficiency and neutrality reasons mentioned above, it should be possible to run a business through a transparent entity without being disallowed CCCTB-treatment. It should furthermore be noted that an exclusion of this entity type would open the door for so-called "cherry picking".

Although transparent legal entities should be included as such, the "corporate tax nexus" implies that the income of such entities would be included in the CCCTB only where the owner is liable to corporate income tax for that income. Thus, an income generated by a transparent entity held (either directly or indirectly through other transparent legal entities) by an opaque entity (such as a limited liability company) would be covered. Conversely, to the extent the transparent entity is held by individuals, the CCCTB would generally not apply, as the income then typically is subject to individual rather than corporate income tax.

As recognized by the Commission, transparent entities seem to raise concerns in at couple of aspects, namely tax residence, the interpretation of transparency itself and inconsistencies between Member States over whether certain entities are transparent or opaque. Apart from the last issue, which will be addressed separately below, we would like to make the following comments.

The problem of *tax residence* is generally avoided by the fact that transparent legal entities frequently are subject to registration. Indeed, this is not always the case as some countries attributes some entity types legal capacity (under general law) without requiring registration provided the business agreement between the parties features certain legal characteristics. A situation could therefore occur where two Member States regard the same entity to be a resident (not implying any tax liability as such) of that state. This can also occur in case an entity is legally registered in one Member States but tax resident in another country. This is, however, not a problem specific for the CCCTB. It exists in the same way today without creating any major difficulties. It is also an issue that could be resolved particularly well within the CCCTB by introducing a common tie-breaker rule.

The concern about the *interpretation of transparency* presumably refers to the existence of so called "quasi-transparent" entities. Such entities are typically transparent either for *some*

taxes (e.g. corporate income tax) but not others (e.g. VAT or tax on real estate) or for *some owners* (e.g. general partners) but not others (e.g. limited partners). These mixed characteristics are sometimes attributed to certain *limited partnerships*.

It should first of all be noted that this entity type is relatively rare and therefore seem to create limited difficulties in practice.[1] This would reasonably be the case also under a CCCTB regime. In addition, to the extent problems arise, they largely refer to the fact that the incoherent characteristics of this entity form triggers such inconsistent tax treatment that will be dealt with below. Nevertheless, some other issues need to be addressed.

To start with, such quasi-transparency that refer to the *type of the tax* would most probably not impose any major difficulties for CCCTB-purposes as the regime only applies to one tax (i.e. corporate income tax). Thus, as long as the quasi-transparency is clearly recognised for CCCTB-purposes, such entities would be regarded as either transparent or opaque.

Where the quasi-transparency instead refers to the *type of the owner*, some administrative difficulties related to the allocation of the taxable income between some of the owners (typically the limited partners of some limited partnerships) and the entity itself (with respect to the income attributable to the general partners) could come up. Although this issue is something that need to be further considered under the upcoming work on the allocation key, it is at least possible to imagine a mechanism based on a *pro rata* allocation depending on the level of ownership of the different owners. Provided that the CCCTB clearly recognises the characteristics of these entities, this should not create any insurmountable problems. In any case, the same limited problem exists today and, if anything, it could be better handled under a common consolidated tax base than under the current situation with 25 different regimes.

To conclude, we believe that transparent entities should be covered by the CCCTB. The difficulties with transparent entities operating cross-border is not so much due to the transparency as such but rather to the fact that the legal characteristics of such entities often are treated inconsistently (or asymmetrical) in the country of the owner and in its home country. As will be shown below, unlike the current situation with 25 different regimes, the CCCTB seems to offer a good opportunity to manage this problem.

3. Non-legal entities which are opaque for tax purposes

This entity group features legal capacity separate from its owners only for tax law purposes. That is, although being liable to corporate income tax as such (i.e. opaque), they do not have any separate legal capacity under general law. These characteristics most notably exist with respect to some *limited partnerships*.

Like quasi-transparent entities, this entity form is very rare. Therefore, whether they are to be included or excluded would presumably be of limited practical importance. Nevertheless, following the "corporate tax nexus" as well as the arguments for a wide application above, nothing speaks for excluding them.

The lack of legal capacity under general law appears to be of limited relevance from a tax law perspective. As these entities are recognized as such for corporate income tax purposes in their home countries, they are typically subject to registration and other formal requirements, which clearly indicate their existence, residence and legal status for tax law purposes. Also, as they are liable to corporate income tax as such, they are surrounded by

[1] At least if the issue of hybrids is not considered. This issue will be dealt with separately below.

the same tax rules and regulations as limited liability companies and other opaque legal entities. Thus, for corporate income tax law purposes they do not deviate much from "regular" opaque entities with general law capacity.

Nevertheless, one potential problem should be considered. As these entities do not feature separate legal capacity under general law, uncertainty could come up with respect to the ownership structure of the entity. That is, if the general law regulations do not provide for a clear legal framework on the share of the ownership between the parties, it could be difficult to define the CCCTB-group with respect to these entities. Even though the relevance of this problem seem to be limited (as the participation typically would be regulated by the parties in the business contract), this could, however, presumably be solved rather easily by requiring a clear ownership declaration which complies with the contractual agreement of the owners for CCCTB-purposes. In any case, this issue does not seem to be of such character that it outweighs the importance of including all entities liable to corporate income tax.

4. Non-legal entities which are transparent for tax purposes

This group of "entities" does not feature any legal capacity separate from its owners either under general law or under tax law. Although the name (*firma*) of such "entities" occasionally can be registered for practical reasons, they are merely contractual agreements between two or more parties and not entities in a strict legal meaning. A silent partnership or a joint venture often features these characteristics.

Despite the wide applicability approach advocated above, we believe that these "entities" should be excluded from the CCCTB. As they have no legal status either under general law or under tax law, they can hardly be regarded as "liable to corporate income tax" – not even indirectly (i.e. unlike legal transparent entities). Thus, the "corporate tax nexus" would not apply. Also, the fact that they can arise informally (the entity agreement can be oral or even implicit and the entity could thus come to existence without the awareness of the parties), the inclusion of such entities would make the definition of a CCCTB-group impossible. Conversely, it would not be possible for the CCCTB-group owner of such entities to exclude from CCCTB its share of income.

<u>Inconsistencies in the tax treatment – the issue of hybrids and reverse hybrids</u>

One particularly important aspect of the "personal scope" refers to the risk of inconsistencies in the tax treatment of entities between two (or more) different states. These situations are commonly known as hybrids or reverse hybrids. A hybrid refers to the situations where an entity is recognised as *opaque* for tax purposes according to its home country but is classified as *transparent* in the country of the owner or source. A reverse hybrid features the opposite characteristics.[2] The outcome of these inconsistencies is sometimes referred to as *asymmetrical taxation*.

Hybrids and reverse hybrids occur because countries fail to recognize the tax law characteristics of foreign entities (i.e. whether they are transparent or opaque) for domestic tax purposes. Instead countries typically classify foreign entities based on their civil law resemblance with domestic entities and tax them accordingly. That is, if the general law

[2] I.e. an entity is recognised as *transparent* for tax purposes according to its home country but is classified as *opaque* in the country of the owner or source

characteristics of e.g. a foreign transparent limited partnership most resemble the general law characteristics of a domestic opaque company, it will be treated as opaque regardless of its actual tax law characteristics in its home country. Alternatively, some countries treat all foreign entities as opaque for domestic tax purposes or allow the owner to elect whether a foreign entity should be considered as transparent or opaque (e.g. US "check-the-box). As the actual tax law characteristics are ignored in all these cases, hybrids or reverse hybrids will frequently occur.

The inconsistent tax treatment in such situations gives rise to either of two tax results – *double taxation* or *double non-taxation*. This follows from the fact that one country recognizes the entity as the relevant taxpayer whereas the other regards the owner as the person liable to tax. Considering the fundamental objectives of consolidation and net taxation, it is obviously essential that these adverse tax consequences are prevented.

For this reason, the CCCTB needs to ensure a consistent (or symmetrical) tax treatment of the eligible entities. That is, the CCCTB must provide for a common classification rule which ensures that an entity which is transparent (or opaque) in its home country is likewise treated as transparent (or opaque) for CCCTB purposes by the other countries involved. This is achieved by attributing decisive importance to the actual tax law characteristics as they are defined in the home country of the entity.

It should be noted that a consistent tax treatment is not only a desired objective, but also a natural and necessary consequence of a CCCTB. Indeed, the tax law characteristics of the various national entity types would presumably still need to derive from the national rules of the entity's home country. However, if there is to be a common tax base with respect to corporate income within the EU, there inherently needs to be a common understanding of who should be liable to tax for that income. This is required in order to ensure a correct and common allocation of the profits. If the CCCTB allows the Member States to classify the eligible entities differently for tax purposes (i.e. as transparent or as opaque), it will lead to a situation where the countries have a different opinion on who should be allocated the income for tax purposes. This would be detrimental for the functioning of the allocation key and would lead to double taxation and double non-taxation despite the existence of a CCCTB.

In designing the suggested classification rule, it is important to recognize the existence and characteristics of quasi-transparent entities. Although this entity group would put some stress on the quality of such a rule, it should in essence attribute decisive relevance to the actual tax law characteristics of an entity as they are defined in its home country. Thus, where, for example, a quasi-transparent entity is transparent with respect to some owners but not others, this would imply that the same treatment should be recognised for CCCTB-purposes.

Other issues

We believe that the CCCTB should provide for a list specifying non-eligible entities. This would promote much needed certainty and predictability. All newly created entity forms would be eligible for CCCTB unless specifically excluded. This would minimize the problem of having to update the list regularly.

To ensure certainty and avoid inconsistencies, the list could also specify the tax treatment of the eligible entities (i.e. whether transparent or opaque etc.).

We would furthermore like to support an approach where the CCCTB is available also with respect to activities carried out in only one Member State. Limiting the CCCTB only to cross-border businesses would impose unnecessary definition problems. It would also create problems where a business reorganizes, e.g. by consolidating its structure to only one Member State. Provided the CCCTB proves to be a competitive tax base, an inclusion of domestic businesses structures would furthermore serve to fulfil the Lisbon objectives.

Finally, we would like to stress that profit distributions from any CCCTB entity, whether opaque or transparent, to another should not be treated as a dividend and must not trigger dividend taxation. Any taxation of such distributions would give rise to double taxation.

On behalf of the UNICE Task Force on CCCTB

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