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Brussels Already Is Changing Europe's Tax Laws

Even without passing a law, the EU is forcing companies to adapt their businesses to higher taxes.

By Dominic Stuttaford

Large corporations have been keenly aware in recent years of mounting public pressure for changes to the international tax system. One "scandal" after another has shed light on strategies companies use under existing laws to minimize their effective tax burdens. Even so, the pace with which legal changes may happen is catching many observers by surprise—and will likely lead companies to change their behaviors, and perhaps even reconsider the economics of their businesses.

The Organization for Economic Cooperation and Development last year released a large-scale model proposal for combating what it calls base erosion and profit shifting, or BEPS—essentially, the use of various transfer-pricing techniques to attribute taxable profits within a multinational to business units in jurisdictions with lower tax rates. Most of the OECD plan doesn't have the force of law, but already last month the European Commission offered its own plan, which might well become law, for implementing elements of the OECD agenda.

One of the basic goals of the OECD proposal, and the theme of Brussels's tax plan, is to change the way companies price intracompany transactions across borders. Existing laws allow some scope to attribute taxable profits to the business unit (and jurisdiction) where an important "cause" for those profits—such as a patent or copyright—is located. New rules would focus to a much greater extent on business activity, control and risk, taxing profits where a company employs staff or has some other market presence, and would introduce new country-by-country reporting requirements.

The commission proposal shows how such a reform will look in practice. Brussels is anxious to reduce use of hybrid instruments, for instance, where debt is deductible for the borrower in one jurisdiction but not taxable in the county where the lender is based. The commission also wants to reinforce the rules taxing a parent company on profits accruing in a low-tax subsidiary; this may force parent companies to consider whether they can continue to use so-called cash-box or similar structures.

Another priority is tax transparency and information exchange. The Brussels plan includes automatic exchange of information among tax authorities, including of rulings on cross-border transactions. One of the suggestions is a ranking of other jurisdictions by reference to the standards that the commission sees as appropriate. If a country is listed as a tax haven, it may mean that an investor's return from operations there is taxed more heavily.

Brussels, and higher-tax EU states, have tried for decades to discourage tax competition within the bloc, with only limited success. Previous measures have lacked teeth, and were often not adopted at all since the requirement of unanimity among Member States allowed low-tax countries to block the changes.

This time, though, the Brussels plan is already part of a more comprehensive attempt to change tax policy. Last month's proposal comes after the competition watchdog launched a number of high-profile investigations suggesting that favorable tax regimes are a form of illegal state aid for companies. There is much debate about whether this is a proper use of competition law, but the cases are creating a political stir on the issue.

And many European countries have already adopted many of the proposals suggested by both the commission and the OECD to a startling degree. To that extent, if the commission doesn't succeed in getting the required unanimity, it may not matter so greatly. Many countries either have or are looking at restrictions on interest deductibility and have closed down or restricted other tax incentives. Anti-hybrid measures are now the norm. Any reduction in interest deductibility and bars on using hybrids are likely to lead to an increase in the after-tax cost of financing, and in the short term may mean that some companies look to restructure their existing borrowings.

Other governments may adopt a hybrid approach of their own. Britain, for instance, has steadily reduced its corporate profits tax rate, to 20% from 28% with another cut on the way by 2020. But it has matched that rate cut with tighter transparency rules and other measures intended to counter old-style tax arrangements.

As a result, the actual adoption of the current proposal may be less important than the political pressure that the commission creates and the underlying behavioral change this new landscape could encourage among companies themselves. The message to companies will be that they can no longer look only at existing tax law and the effective tax rates they can achieve under that law when arranging their financial affairs. Companies will have to accept that it may not be possible to structure as tax-efficiently as they used to and that reducing their effective rate too low could see them run the risk of adverse publicity and media scrutiny, which may in turn damage their brand.

That amounts to a major change for those international companies planning the economics of their business amid a potentially significant cost of complying with the new regime. Managers and policy makers alike need to be ready for the consequences.

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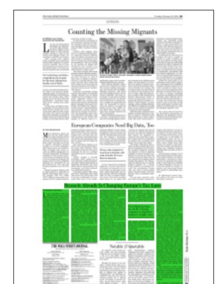

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