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BEFIT: A Company Tax System Layering Exercise for the Internal Market (Part 1)

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This is the first part of the authors' blog on the Proposal for a Council Directive on Business in Europe: Framework for Income Taxation (BEFIT) that the European Commission (EC) published on 12 September 2023. In this part we present an outline of the backgrounds and basic elements of the BEFIT proposal. Reference is made to the second part of this blog for our observations on the envisaged EU corporate tax framework BEFIT proposal.

1. Introduction

On 12 September 2023, the European Commission (EC) published a Proposal for a Council Directive on Business in Europe: Framework for Income Taxation (BEFIT) (the BEFIT proposal).^[1] The BEFIT proposal introduces a common company tax base for large European companies (annual turnover of more than €750 million). BEFIT replaces the 2016 Directive proposals for a Common Corporate Tax Base (CCTB)^[2] and a Common Consolidated Corporate Tax Base (CCCTB)^[3]. Groups with an annual turnover below the €750 million threshold and that draw up consolidated financial statements can opt for the application of the new rules. The envisaged implementation date of the BEFIT Directive is 1 January 2028, after which the Directive will apply from 1 July 2028.

The BEFIT proposal builds on, inter alia, the EC's Communication 'Business Taxation for the 21st Century' of 18 May 2021^[4] and fleshes out the EC's existing tax reform agenda for the coming years. The BEFIT proposal is accompanied by a proposal for a Directive on transfer pricing (the EU TP Proposal)^[5]. The EU TP Proposal harmonises the arm's length principle within the internal market. On the same day, the EC published a proposal for a Directive for a Head Office Tax system for micro, small and medium sized enterprises (the HOTS Proposal). The HOTS Proposal introduces the possibility for small and medium-sized enterprises to calculate profits of permanent establishments within the EU according to the corporate income tax (CIT) base determination rules in the Member State of the company's head office.^[6] The EU TP Proposal and HOTS Proposal are scheduled to enter into force on 1 January 2026.

With the release of the BEFIT proposal, the EU Member States are set to engage in discussions in

the upcoming period. The adoption of the proposal hinges on securing a unanimous vote from all EU Member States. Many anticipate that the deliberations surrounding BEFIT will extend over several years, given its premature introduction at a time when EU Member States are grappling with the implementation of their Pillar Two rules. Adding to the complexity, the BEFIT proposal introduces a wholly new company tax system. Notably, Finland^[7], Sweden^[8], and the Netherlands^[9] have already articulated their perspectives on BEFIT. It's worth noting that the potential success of the proposal is a political issue that the authors do not explicitly address. Whether the proposal will gain traction and support remains a significant aspect that may influence the ongoing discussions. This said, the article will delve into the proposed directive and seeks to offer some insightful comments.

2. How would BEFIT operate?

2.1 General

The BEFIT proposal introduces an aggregated common company tax base for so-called BEFIT groups, a *single tax base*, which is distributed among the EU Member States for the further application of their domestic Corporate Income Tax (CIT) rules on the basis of a 7-year transitional distribution mechanism. The following is a brief explanation of the personal scope (*who to tax*), substantive scope (*what to tax*) and geographical scope (*where to tax*) of the BEFIT proposal, accompanied by some comments on the operation of the proposal of an administrative nature (*how to tax*).

2.2 Who does BEFIT tax?

The BEFIT proposal affects EU subsets of groups with a combined annual turnover of €750 million or more and includes the entities whose ultimate parent entity holds an interest in terms of ownership rights or profit rights of 75% or more.^[10] For groups with an ultimate parent entity established outside the EU, an additional criterion is that the annual turnover within the EU, in the last 4 years prior to the year in which the Directive first becomes applicable to the group concerned, must be €50 million or more and this annual turnover must represent at least 5% of the total annual turnover of the group concerned.^{[11][12]} (materiality requirement). For companies with an annual turnover below the €750 million threshold and which draw up consolidated financial statements, the BEFIT regime is available for an optional five-year period in each case.^[13] The rules will apply to the intra-EU part of the groups concerned, i.e., their EU subsets. These are the group entities established within the EU and the permanent establishments located within the EU of non-EU group entities established outside the EU.

2.3 What does BEFIT tax?

The single tax base in the BEFIT proposal is derived from the financial reporting standard used by the ultimate parent entity in the preparation of the consolidated financial statements (e.g. IFRS).^[14] As with the Pillar Two Directive, the starting point of the provisional BEFIT tax basis calculation is the result based on an accepted accounting standard. A number of fixed adjustments are then made. These adjustments differ from those used under Pillar Two to calculate the GLoBE income for Pillar Two purposes.^[15]

The proposal also introduces a regime for revaluations of qualifying participations. It is worth mentioning that the BEFIT proposal introduces a harmonized generic interest deduction limitation mechanism, based on the EBITDA deduction limitation laid down in the Anti-Tax Avoidance Directive (ATAD) of 2016.^[16] Excessive interest as determined according to the ATAD-EBITDA rule and paid by the relevant BEFIT group entity to group entities that are not part of the EU subset of the group shall not be deductible for BEFIT base determination purposes. It also stipulates that shipping income and income items covered by a tonnage tax regime in the EU Member States are not part of the BEFIT base.^[17] A roll-over relief measure applies to reinvestments.^[18] BEFIT also provides adjustments that follow from a tax regime for, for example, real estate and intangible assets. Subsidies for the acquisition, construction and improvement costs of fixed assets that are depreciable are exempt from the BEFIT basis.^[19] If the BEFIT basis is negative, such is carried forward and offset against the next year in which the BEFIT basis is positive.^[20]

2.4 Where does BEFIT tax?

Regional Blending

The single tax base accordingly established is determined at BEFIT group entity level (separate accounting).^[21] More specifically, the common basis of individual BEFIT group entities is aggregated at BEFIT group level, and also across the national borders of the EU Member States. This creates a cross-border EU taxable profit pooling regime (loss imports; no fiscal consolidation).

In Pillar Two terms, the intra-EU netting of business income essentially leads to regional blending, contrasting with the jurisdictional blending approach in the Pillar Two system. It's worth mentioning that, due to the regional blending à la BEFIT, the jurisdictional effective tax rate in an EU Member State for Pillar Two purposes may fall below 15%. We refer you to section 3.3 of this article for some further elaboration and a numerical example.

Transitional distribution mechanism

A positive BEFIT company tax base is distributed among the EU Member States through a transitional distribution mechanism.^[22] This mechanism applies for a transitional period of 7 years, specifically for fiscal years between 1 July 2028 and 30 June 2035.^[23] Before the end of the third year after the entry into force of the Directive, the EC may propose another attribution mechanism.^[24] If this does not happen, or if this proposal is not adopted before the end of the transitional regime, the transitional regime will become final.

After the end of the 7-year transition period, the idea is that a switch will be made to a permanent distribution key to be developed by the EC which can be based on a formula (formulary apportionment).^[25] It is reported that the EC is putting its formula ideas on hold in order to get the EU Member States on board. The argument would then be that the proposed transitional distribution mechanism doesn't differ significantly in terms of tax revenues from the current rules. Moreover, EU Member States with Pillar Two have already committed to base coordination.

No WHT

EU Member States may not apply withhold taxes on transactions between the BEFIT group entities.^[26]

National CIT rules

Following the application of the apportionment mechanism, EU Member States will be able to apply their national CIT rules to their allocated part of the single tax base, such as national deduction limitations and/or base-narrowing measures such as investment allowances and patent box regimes.^[27] EU Member States can also apply their tax grouping regimes at this stage. In doing so, BEFIT harmonizes part of the taxable base within the EU and thus pushes variants of the concept of profit for individual EU Member State CIT purposes further into the background. EU Member States then apply their national rates. Of course, the 15% minimum rate under the Pillar Two system will have to be taken into account, at least if and to the extent that these EU Member States wish to avoid any Pillar Two top-up taxation.

2.5 How does BEFIT tax?

One Stop Shop

The BEFIT proposal provides for a ‘one-stop-shop’ tax administration system.^[28] A BEFIT information return is provided. The system is to some extent similar to that of the GloBE Information Return (GIR) in the Pillar Two system. The ultimate parent entity of the BEFIT group, i.e., the (ultimate) parent entity, is designated as the primary BEFIT information declaration submitting group entity.^[29] This is when this ultimate parent entity is established in the EU. If the ultimate parent entity is not established in the EU, the BEFIT group may designate an EU group entity for that purpose.^[30] The BEFIT information return will be submitted to the tax authorities of the EU Member State of establishment, which will then ensure the further dissemination of the information declaration to the EU Member States where the group in question operates.^[31]

It follows from the BEFIT proposal that it should be possible to amend a tax assessment without a time limit if a tax authority or court in another EU Member State issues a ruling that (indirectly) also affects the CIT basis of one of the EU Member States concerned.^[32] This raises the question of whether and to what extent this could in practice lead to a tax assessment in a Member State not being irrevocably established. If this is the consequence, it will be at odds with the notion of formal legal effect of government decisions and thus the legal certainty and legitimacy of government interventions towards taxpayers. The formalization process, in addition, will continue to be in the hands of the individual EU Member States at a decentralized level. The same applies to any tax-administrative procedures or any tax litigation appeal proceedings.

The BEFIT proposal also indicates that a BEFIT team should be installed: a team of tax officials that is from the various EU Member States in which the group involved is active.^[33] Such a BEFIT team would be equipped with an online collaborative tool and would mutually exchange relevant tax information and would also provide advance legal certainty in relation to certain elements of BEFIT’s legal operation.^[34] The BEFIT team will have to be sufficiently equipped to resolve any disputes between tax authorities on the tax base.

Traffic Light System

For the sake of administrative simplicity, a so-called ‘traffic light system’ will be introduced for the arm’s length pricing of affiliated transactions with group entities outside the BEFIT group.^[35] The envisaged traffic light system is a risk analysis system for the tax authorities of the EU Member States to assess the pricing of so-called low-risk activities (distribution activities by low-risk distributors, manufacturing activities by contract manufacturers) on the basis of a public benchmark (based on the transactional net margin method; TNMM) on their arm’s length nature and, depending on the position of the transfer price employed in the interquartile range, to place them in one of three risk zones (low/medium/high). The tax authorities will then be able to tailor their efforts to the sub-population of the transactions in question that is considered to be the riskiest. Moreover, the administrative transfer pricing traffic light system is separate from the substantive transfer pricing application.

3. Closing remarks

On 12 September 2023, the European Commission (EC) published a Proposal for a Council Directive on Business in Europe: Framework for Income Taxation (BEFIT), the BEFIT proposal. In this part of a two-part blog we outline some of the backgrounds and the general operation of the BEFIT proposal. In the second part of this article, we are presenting our observations on the envisaged EU corporate tax framework.

^[1] The authors express their gratitude to their PwC colleague Anna van Beek for her meticulous work in researching and adding the necessary footnotes to this article.

^[2] See European Commission, Proposal for a Council Directive on a Common Corporate Tax Base, COM(2016) 685 final, 25 October 2016 (withdrawn).

^[3] See European Commission, Proposal for a Council Directive on a Common Consolidated Corporate Tax Base, COM(2016) 683 final, 25 October 2016 (withdrawn).

^[4] See BEFIT proposal, page 3; European Commission, Communication from the Commission to the European Parliament and the Council, Business Taxation for the 21st Century, COM(2021) 251 final, 18 May 2021 (available at https://taxation-customs.ec.europa.eu/communication-business-taxation-21st-century_en).

^[5] See European Commission, Proposal for a Council Directive on Transfer Pricing, COM(2023) 529 final, 12 September 2023 (available at https://eur-lex.europa.eu/resource.html?uri=cellar:35311f2e-5210-11ee-9220-01aa75ed71a1.0001.02/DOC_1&format=PDF).

^[6] See European Commission, Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU, COM(2023) 528 final, 12 September 2023.

[7] See <https://valtioneuvosto.fi/-/10623/hallitus-suhtautuu-varauksella-yritysten-tuloverotusta-euroopassa-koskevaan-befit-kehukseen> (Finnish).

[8] See <https://www.regeringen.se/faktapromemoria/2023/10/202324fpm9/> (Swedish).

[9] See <https://open.overheid.nl/documenten/e0787088-e0c7-428f-a932-0aa7f58cadf6/file> (Dutch).

[10] See Article 2, par. 1, and Article 5 BEFIT proposal.

[11] For companies with an annual turnover below the €750 million threshold and which draw up consolidated financial statements, the BEFIT regime is available for an optional five-year period in each case. See article 2, par. 7 BEFIT proposal.

[12] See Article 2, par. 2 BEFIT proposal. It is important to note meeting just one of the conditions, according to the literal wording of the provision as it currently reads, is sufficient to be excluded from the scope, without the requirement of meeting both conditions simultaneously.

[13] See Article 2, par. 7 BEFIT proposal.

[14] See Article 7 BEFIT proposal.

[15] For example, a 95% participation exemption regime applies that deviates from the participation exemption in Pillar Two, the double tax relief system in the Parent-Subsidiary Directive as well as the various participation exemption regimes in the domestic CIT systems of the EU Member States. See Article 8, and Article 9 BEFIT proposal.

[16] See Article 13 BEFIT proposal.

[17] See Article 15 BEFIT proposal.

[18] See Article 18 BEFIT proposal.

[19] See Article 19 BEFIT proposal.

[20] See Article 42, par. 2 BEFIT proposal.

[21] See Article 42 BEFIT proposal.

[22] See Article 45 BEFIT proposal.

[23] See Article 45, par. 1 BEFIT proposal.

[24] See Article 45, par. 9 BEFIT proposal.

^[25] See BEFIT proposal, Explanatory Memorandum, Sec. 5, page 15.

^[26] See Article 43 BEFIT proposal.

^[27] See Article 45, par. 2, BEFIT proposal.

^[28] See Article 57 BEFIT proposal.

^[29] See Article 3, par. 10 BEFIT proposal.

^[30] See Article 56 BEFIT proposal.

^[31] See Article 57 BEFIT proposal.

^[32] See Article 64 BEFIT proposal.

^[33] See Article 60 BEFIT proposal.

^[34] See Article 61 BEFIT proposal.

^[35] See BEFIT proposal, chapter IV.

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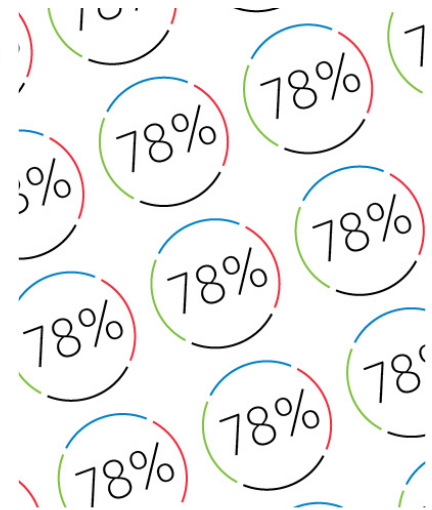
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