SNAPSHOT

Critical thinking at the critical time™

22 MAY 2013

EU TAX: SISYPHUS REACHING THE SUMMIT?

A SHARED NEW SENSE OF PURPOSE TO INCREASE THE FAIRNESS OF THE TAX SYSTEM PUTS EU TAX POLICY INTO THE LIMELIGHT. GOVERNMENTS HAVE HAD TO TAKE PAINFUL BUDGET MEASURES THE END OF WHICH ARE NOT IN SIGHT. TAPPING INTO NEW SOURCES OF TAX INCOME BY FIGHTING TAX EVASION AND INTRODUCING NEW TAXES (SUCH AS FTT), ARE NOW POLITICAL PRIORITIES. HOWEVER, DESPITE THIS NEW MOMENTUM, REACHING THE SUMMIT MIGHT ELUDE SISYPHUS STILL…DECISION MAKING REMAINS FRAUGHT WITH OBSTACLES. IN THE US DISCUSSIONS TAKE PLACE IN A DIFFERENT CONTEXT BUT ARE FOCUSED ON THE SAME ISSUES AND FLOW FROM THE SAME FISCAL SITUATION.

The financial crisis has become a sovereign debt crisis which has developed into a full-fledged economic crisis. After nearly five years of fire fighting, late night crisis meetings and austerity budgets, European politicians are faced with the existential challenge of defending the social contract between governments and voters and regaining trust. Attention has thus turned to finding ways to pay back what has been spent, maximise State revenue and ensure that painful measures are distributed fairly. This means that today taxation is not only an important policy matter but also a political one.

THE DIFFICULTIES OF NEGOTIATING EU TAX LEGISLATION

Taxation policy has historically been the prerogative of national governments in the EU. It is clear why: tax income is the basis for all national policies. The principle of unanimity voting on European tax initiatives has ensured this has been reflected in European internal negotiations. The result is a Europe of 27 with a variety of approaches to tax, some harmonised such as the fundementals of VAT law, or some with remarkable differences, such as corporate tax rates. But, in an internal market, tax remains a cross-border issue.

Therefore the European Commission has consistently sought to modernise and harmonise methods of application and collection of taxes, often to see their proposals left stranded in Council negotiations. However, a watershed moment might now have taken place.

Unexpectedly Member States of the European Union, the European Parliament and the European Commission share an objective to maximise government revenue and ensure that "*everybody pays their share of taxes*". Furthermore, a development from outside the EU is now additionally driving this agenda.

TAX WARS: IN A TAX HAVEN FAR FAR AWAY…

US legislation titled the Foreign Accounting Tax Compliance Act (FATCA), seems to have unblocked European negotiations that have been stalled for many years. FATCA, which the US is negotiating with over 50 countries, will look to collect details of accounts of every US citizen or company located abroad, either through agreements with national governments or through the submission to the IRS by foreign financial institutions. By forcing the hand of the Swiss to sign up to FATCA, the US has shown that it is possible to step up the fight against tax evasion, initiating European debates on cracking down on tax evasion, both inside the EU and between the EU and third countries.

The 6 largest EU Member States have now proposed to establish a European FATCA between themselves, which they hope to roll out to the rest of the EU and even globally through the G8, G20 and the OECD.

In parallel, the European Commission presented its “Action Plan to strengthen the fight against tax fraud and tax evasion” at the end of 2012.

Savings Directive: Key element of this action plan is to finalise the negotiations on the proposal to modernise the Savings Tax Directive. This file has been under negotiation in Council since November 2008, and is intended to close some loopholes by enabling the automatic cross-border exchange of information between Member State tax authorities on income derived from a variety of products such as pension funds, trusts and investment funds. The Savings Tax Directive, in conjunction with the fight against tax evasion and tax fraud are contentious issues for Member States such as Luxembourg and Austria which have notorious banking secrecy rules. These two nations are seeing mounting pressure to drop their opposition to the proposal. Luxembourg and Austria have for years stuck to maintaining their “transitional” period which would end when states such as Switzerland, Andorra, San Marino and Monaco also agree to such automatic exchanges of information. This has resulted in Luxembourg promising in principle to relax its rules by 2015 whilst Austria is being forced to make a decision to comply quickly before a European Council meeting on 22nd May.

Tax Governance: The European Commission Action Plan announces the establishment of a platform for good tax governance, composed of experts from Member States and stakeholder representatives, tasked with providing assistance in preparing reports on the application of its recommendations on aggressive tax planning and on standards of good tax governance for third-countries. The Commission will also set up a web-portal for EU Tax Identification Numbers (TINs) in order to publish country-by-country descriptions of tax structures in conjunction with the Taxpayers Code listing best practices for dealings between tax payer and tax authority.

OTHER EUROPEAN TAX INITIATIVES

“The Steam roller will not be stopped” European Tax Commissioner Semeta said recently. He is proposing a raft of policies designed to increase government revenue and reduce public debt. Some policies are moving faster than others.

The first draft of a **Financial Transaction Tax** (FTT) in 2011 was drawn up to raise revenues on an industry deemed not to pay enough, and at the same time mitigate its negative exuberances symbolised by numerous bank bail-outs. This proposal was not accepted by many Member States including the UK, Luxembourg and Sweden. Therefore agreement between 27 Member States was not feasible.

However, this was not the end of the proposal. The rejection by the EU 27 has led Germany and France, together with 9 other “willing” Member States, to start a so-called Enhanced Cooperation Procedure to introduce the FTT in their jurisdictions. As things stand, the FTT is still in a maelstrom of uncertainty; on 14th April the UK put forward a legal challenge adding more pressure to an increasingly unlikely implementation date of January 2014.

Other files have not moved as quickly. The **Common Consolidated Corporate Tax Base (CCCTB)** looks to reduce compliance and administration costs for EU businesses by harmonising tax-base calculations and setting up a “one stop shop” that will provide EU companies with a single reference point when dealing with tax administration. The arguments for such a proposal are that it could ease barriers to cross-border trade and make savings of 2 billion euros for business. Countries like France, Spain and Italy have backed the idea, but the doubts remain whether these benefits sufficiently outweigh the costs of restructuring the complex and varied legal tax structures that exists in different Member States today.

VAT is the most harmonised of taxes. Member States have freedom on the rates of VAT as long as they are within the boundaries of EU rules. Indeed, Directive 2006/112/EC provides a legal framework on VAT rules for commercial activities and imports in the EU, where Member States may reduce rates up to a limit of 5% for a specified list of goods and services. The VAT system is next in line for revision, as the Commission looks to modernise the application of VAT law by streamlining different existing processes to make them more efficient. In line with the fight against tax fraud, a Quick Reaction Mechanism will be looked at as a possible solution for prompt action in this area.

ON THE OTHER SIDE OF THE POND

In the US tax is also a key policy issue. Obviously the fiscal situation is the key debate also in Washington.

US government fiscal situation

The US budget is a primary concern. The US fiscal outlook for the next ten years has improved in recent months, but remains very worrisome. The US debt-to-

GDP ratio skyrocketed from 36% in 2007 to around 75% today. With recovery from the financial crisis and resumption of moderate growth—combined recently with several rounds of discretionary spending cuts, sequestration, and tax increases—the debt-to-GDP ratio is projected, on current trajectory, to remain below 80% for the next decade. Over the medium to long-term, however, an aging population will strain entitlement programs and the Affordable Care Act will begin sharply increasing government spending. Under the status quo, the ratio of debt-to-GDP is projected to begin rising rapidly again next decade, exceeding 90% by 2033.

To address this problem, the President and representatives of the House and Senate have each put forward a budget. However, the parties are far apart in their approach (spending cuts vs. tax hikes): Most Republicans will strongly resist a debt ceiling increase without substantial new spending restraint; most Democrats will strongly resist substantial new spending restraint without new tax increases; and most Republicans will strongly resist any new tax increases, period. Watch for political turbulence as the next debt ceiling deadline approaches, with the more likely outcomes being either kicking the can slightly further down the road or a significant debt ceiling increase passed through the House with mostly Democratic votes (probably signalling the end of John Boehner's speakership).

Fairness in taxes. Although in a different context, the US tax reform discussions and the ideas contained in President Obama's budget for 2014 have a focus on the same tax theme as in the EU: there is a call for individuals and businesses to pay their "fair share".

In the **individual tax proposals** this is demonstrated by two eye-catching changes. The first is the so-called Buffett Rule, labelled a "Fair Share Tax", requiring that households with incomes over $1 million pay at least 30% of their income, less a credit for charitable giving, in taxes. The second is to tax carried (profits) interests as ordinary Income. This would eliminate the ability of financial managers to pay the lower capital gains tax rate on their income.

As regards **corporate tax proposals**, the focus is on the "underpayment" of corporate tax by multinational companies through tax planning. FATCA is the clearest example. The President calls for Congress "to immediately begin work on corporate tax reform that will close loopholes, lower the corporate tax rate, encourage investment here at home, and not add a dime to the deficit. Representatives from the House and the Senate have said that US tax reform will seek to ensure "that companies can't avoid paying tax on income they earn in the US by pretending that they earned it in an overseas tax haven instead."

Although most officials recognise that the much-maligned tax planning results from tax competition among different jurisdictions, discussion at the leader-level has focused on channelling a populist but misguided belief that companies should pay tax in proportion to their sales or revenue in that particular jurisdiction and anything else is "unfair."

Other noteworthy tax proposals are:

- Minimum tax on foreign earnings: This proposal was not included in previous budgets and is, in effect, a partial repeal of the current deferral for foreign earnings. The precise impact depends on the minimum tax rate.
- Tax profits over a certain margin, associated with US intangibles and earned in low-tax foreign jurisdictions: This base erosion proposal could be an alternative to a minimum tax and would subject a portion of profits earned in low-tax jurisdictions to US tax.
- Limitation of the tax deduction for interest expenses based on the proportion of earnings that are earned overseas and not repatriated to and subject to tax in the United States.
- Disallow tax deductions for the cost of moving production overseas, but provide a new 20% tax credit for the cost of bringing production back to the United States.
- Limitation of the ability to tax-efficiently transfer businesses offshore by expanding the definition of "intangibles" to include workforce in place, goodwill and going concern value. These provisions could increase the cost of certain tax planning prospectively.
- Impose additional limits on the use of foreign tax credits

The budget is also noteworthy for what it does not include. Unlike previous budgets, CFC look-thru, active financing and other temporary business tax provisions are not included. The CFC look-through rule which allows global US companies to mobilize international cash without incurring US tax is particularly important because it allows multinationals to tax-efficiently mobilize hundreds of millions of dollars out of countries each year.

Multinational corporations should be aware of ongoing policy initiatives to address the issue and, even in their absence, expect continued pressure to alter their planning strategies.

FTI CONSULTING

BRUSSELS

Hans Hack
Senior Director
Financial Services
Avenue Marnix 23 - 1000 Brussels
+32 (0)2 289 0875
Hans.Hack@fticonsulting.com

Luc Cade
Consultant
Financial Services
Avenue Marnix 23 - 1000 Brussels
+32 (0)2 289 0960
Luc.cade@fticonsulting.Com

LONDON

Philip Feibusch
Senior Managing Director
European Tax Advisory
Davidson Building, 5 Southampton Street, London, WC2E 7HA
+44 20 7979 7477
Philip.Freibusch@fticonsuliting.com

Dario Garcia
Senior Managing Director
European Tax Advisory
Midtown, 322 High Holborn, London, WC1V 7PB
+44 20 3077 0563
Dario.Garcia@fticonsulting.com

WASHINGTON DC

Tom Crawford
Senior Managing Director
325 7th Street Northwest, Suite 400
Washington, DC 20004, United States
+ 1 202 567 2901
Tom.Crawford@fticonsulting.com