

## Chapter 2

# THE LANDSCAPE FOR EU COMPANY TAX REFORM

Through the Treaty of Rome, six European countries founded the European Economic Community fifty years ago and committed to “lay the foundations of an ever closer union among the peoples of Europe.”<sup>1</sup> In the half century since then, the European Economic Community has undergone profound changes in how it operates as it has grown to a membership of twenty-five countries and become the European Union. Yet, the over-riding economic goals remain the same: To adopt policies and laws that will help create a common market; to abolish obstacles to the free movement of goods, services, labor and capital; and to provide for freedom of establishment.

## 2.1 FOREIGN DIRECT INVESTMENT AND TAXATION

The European Union’s economic structure has evolved since the mid-20<sup>th</sup> century. Currency exchange controls no longer exist among Member States. Twelve Member States use a single currency. The Member States are adopting common international financial reporting standards and they are eliminating withholding taxes on cross-border intra-company dividend, interest, and royalty payments. They have established procedures to create a “European Company” and are removing the tax disadvantages to cross-border mergers in the EU.

The reduction in internal barriers in the Single Market may be a factor in the growth in foreign investment into the European Union. Since the European Community launched the Single Market initiative in 1992, foreign direct investment in the EU has grown more than twice as fast as EU income. Foreign direct investment flows in and out of the EU reached record levels at the end of the 20<sup>th</sup> century.<sup>2</sup> The number of cross-border mergers and acquisitions within the EU rose by 55 percent during the 1990s; intra-EU mergers and acquisitions amounted to roughly 70 percent of the total during the 1990s.<sup>3</sup>

In addition to the reduction in non-tax barriers, the overall reduction in corporate income tax rates in the European Union may also help explain these increased flows. The average tax rate in the EU-15 Member States is nearly ten percentage points lower now than it was a decade ago. A second factor is the downward pressure on company tax rates as the European Union accepts new members. Apart from Malta and the Czech Republic, the tax rates in the new Member States are generally well below the rates in the EU-15 (except for in Ireland). Table 1 shows this downward trend in tax rates for the EU-15 and the ten new Member States for selected years.

The growth in cross-border investment flows has made EU businesses highly aware of the additional costs they incur when they do business in another Member State. The fact that compliance burdens increase when EU companies expand across border should come as no surprise. Each EU Member State largely operates its company tax system as if it were an autonomous system with few links to other EU Member States.<sup>4</sup>

The Commission Study (2002) finds that the variation in Member State tax bases is so great that it is not possible to identify a common approach among ten central tax base elements. Some Member States offer accelerated depreciation, while others offer straight-line depreciation. Some value inventory on a first-in, first-out basis; others follow the last-in, first-out rule. Subject to Commission approval under state aid provisions, all offer investment tax credits and tax incentives for specific forms of investment. Depreciation rates vary across Member States with the type of asset, such as industrial buildings, intangible property, plant, machinery, and office equipment. Finkenzeller and Spengel (2004) show that the addition of ten new Member States has reduced the average level of corporate tax rates, but has not reduced the variation in company tax systems.

The Commission identifies the existence of twenty-five separate tax systems in the EU as the underlying cause of these additional compliance burdens. As the Commission Study (2002) notes, “The need to comply with a multiplicity of different rules entails a considerable compliance cost and represents in itself a significant barrier to cross-border economic activity” in the European Union.

To describe the tax situation in the enlarged European Union as a “tax jungle” is not far off the mark. Nor, in the midst of this tax jungle is it surprising that EU multinational enterprises seek a path toward a “better” tax system.

## **2.2 CROSS-BORDER TAX ISSUES IN THE EUROPEAN UNION**

### ***Cross-border loss compensation***

In terms of specific obstacles to cross-border investment in the European Union, the Commission Study (2002) reports “the absence of cross-border loss

Table 1. Corporate income tax rates in the EU-15 and in the new EU Member States, selected years

<i>EU-15 Member State</i>	<i>1995</i>	<i>2000</i>	<i>2004</i>	<i>2005</i>
Austria	34%	34%	34%	25%
Belgium	40.2	40.2	34	34
Denmark	34	32	30	30
Finland	25	29	29	26
France	36.7	36.7	35.4	35.4
Germany	56.8	51.6	38.3	38.3
Greece	40	40	35	35
Ireland	40	24	12.5	12.5
Italy	52.2	41.3	37.3	37.3
Luxembourg	35	35	30.4	30.4
Netherlands	35	35	34.5	34.5
Portugal	39.6	35.2	27.5	27.5
Spain	35	35	35	35
Sweden	28	28	28	28
United Kingdom	33	30	30	30
<i>New Member State</i>	<i>1995</i>	<i>2000</i>	<i>2004</i>	<i>2005</i>
Czech Republic	41%	31%	28%	26%
Cyprus	25	29	15	10
Estonia	26	26	26	26
Hungary	19.6	19.6	17.7	16
Latvia	25	25	15	15
Lithuania	25	25	15	15
Malta	35	35	35	35
Poland	40	30	19	19
Slovakia	40	29	19	19
Slovenia	25	25	25	25
Average EU-15	38.0%	35.3%	31.4%	30.6%
Average new EU-10	30.6	27.4	21.5	20.6

*Note:* As of 2000 and until 2008, Estonia taxes distributed earnings at 26 percent but exempts retained earnings from tax. Source: Table II-5.1 in Structures of the taxation systems in the European Union, Eurostat (2004).

relief or full consolidation at the EU level as one of the major obstacles that requires action as a matter of priority.” Table 2 shows that although all but a half-dozen Member States offer domestic loss offsetting, only a handful of Member States (Austria, Denmark, and Italy) generally allow companies to offset losses of foreign subsidiaries against domestic profits.<sup>5</sup>

The lack of cross-border compensation for losses of foreign subsidiaries has several potential consequences. It may affect whether a company organizes its foreign operations as branches or as subsidiaries; it may also affect whether a company decides to undertake foreign investment at all.

Table 2. Domestic and cross-border loss offsetting in the EU Member States, 2005

	Domestic Loss Offsetting		Group Taxation	
	Carry Back	Carry Forward	Domestic	Cross Border
Austria	none	unlimited	loss transfer	yes
Belgium	none	unlimited	no	no
Cyprus	none	unlimited	loss transfer	no
Czech Rep.	none	5 years	no	no
Denmark	none	unlimited	pooling	yes
Estonia	n.a.	n.a.	n.a.	no
Finland	none	10 years	loss transfer	no
France	3 year option	unlimited	pooling	limited
Germany	1 year option	unlimited	pooling	no
Greece	none	unlimited	no	no
Hungary	none	unlimited	no	no
Ireland	1 year option	unlimited	loss transfer	no
Italy	none	5 years	pooling	yes
Latvia	none	5 years	loss transfer	no
Lithuania	none	5 years	no	no
Luxembourg	none	unlimited	pooling	no
Malta	none	unlimited	loss transfer	no
Netherlands	3 year required	unlimited	tax consolid.	no
Poland	none	5 years	pooling	no
Portugal	none	6 years	pooling	no
Slovakia	none	5 years	no	no
Slovenia	none	5 years	pooling	no
Spain	none	15 years	pooling	no
Sweden	none	unlimited	loss transfer	no
U.K.	1 year option	unlimited	loss transfer	no

Notes: n.a. means 'not available.' Source: Commission (2005b).

Providing cross-border loss compensation, however, does not address a fundamental issue facing EU multinational enterprises. Even if each Member State offered cross-border loss offsetting, each entity would still calculate its own tax base. Enterprises would be able to offset losses, but they would not have a single consolidated tax base and they would still face the transfer pricing obstacle, as discussed below. No Member State offers what the European Commission and EU businesses have endorsed: cross-border consolidation of EU-level profits.

### *Transfer pricing documentation requirements*

In addition to the difficulties they face establishing arm's length transfer prices, the EU businesses report another concern about the transfer pricing process: The growing documentation burden.

If a taxpayer fails to follow the arm's length principle when setting transfer prices, the tax authority may reallocate income to obtain an arm's length result.<sup>6</sup> To avoid such a re-allocation, the taxpayer must prove that it established its transfer prices on an arm's length basis. Part of this proof is demonstrated through supplying documentary evidence.

As a result, complying with the arm's length principle can become a burdensome process.<sup>7</sup> The OECD (2004b) shows that all of the EU members in the OECD now require companies to maintain written records. The European Commission (2004d) survey of compliance costs showed that more than 80 percent of the additional compliance costs that arise when conducting cross-border business relate to transfer pricing documentation requirements.

To some extent, these greater transfer pricing enforcement efforts are a new development for many EU governments. As Durst and Culbertson (2003) suggest, countries outside of the United States in the past generally were "content with the historical levels of enforcement (or, as often seems to have been the case, non-enforcement) generally found around the world."<sup>8</sup>

That situation has changed. EU and non-EU companies surveyed by Ernst & Young (1997, 1999, 2001, 2003) report that tax authorities are increasing their focus on transfer pricing enforcement. In its 1999 Report, for example, Ernst & Young report a "hardening attitude on tax-driven transfer pricing" among 19 EU and non-EU countries surveyed. The 1999 report continues that "[t]he strict U.S.-initiated transfer pricing model (with accompanying documentation requirements, penalties, and enforcement) is spreading quickly to other nations around the globe and adding to the strain."

The Ernst & Young 2003 Global Survey reports that multinational companies view audits by tax authorities as the rule, rather than an exception. For example, 9 out of 10 Danish respondents, 8 out of 10 German respondents, and 7 out of 10 Finnish respondents indicate that tax revenue authorities are paying close attention to transfer pricing issues, thus triggering additional transfer pricing disputes.

The European Commission (2003b) identifies certain incompatibilities with the transfer pricing process and the Internal Market. As reported in its Internal Market Scoreboard, although EU multinational companies have arrangements to solve the transfer pricing problem, "the whole process of computing the correct price, preparing the supporting documentation and finding agreements to resolve disputes is costly and time consuming for both business and administrations."

In light of the increased emphasis on the proper application of the arm's length principle, the criticism by EU businesses that complying with the transfer pricing rules may create an unreasonable compliance burden is understandable. If EU tax authorities had generally taken a "relaxed view" towards transfer pricing practices until the 1990s, then the fact that the transfer pricing rules "required" companies to apply the arm's length principle did not create a significant compliance burden.<sup>9</sup> If EU tax authorities have strengthened their enforcement

of the arm's length principle and are penalizing taxpayers for failing to provide sufficient documentary proof, then EU businesses may be open to alternative, less burdensome methods of allocating their tax bases across the Member States.

### *The view from EU governments*

EU governments face challenging issues enforcing the separate accounting with arm's length pricing principle. The European Commission (2004a) explains that EU Member State tax systems are increasingly vulnerable to "tax evasion and fraud which exploits precisely the weaknesses of separate accounting . . . Moreover, the current system is costing both companies and tax authorities dearly in terms of administrative and compliance costs." As shown earlier, as the barriers to cross-border investment have fallen, EU multinationals have expanded their operations throughout the European Union. This increased cross-border expansion creates additional concerns for tax authorities that their tax bases may become increasingly vulnerable to erosion.

This concern is particularly great in the Member States with relatively high tax rates. As long as tax rates differ across Member States, multinational enterprises have an incentive to locate their income in low-tax Member States and their expenses in high-tax Member States. For example, every 100 euros of profits taxed at 20 percent instead of at 45 percent potentially saves the MNE 25 euros. Ignoring the potentially offsetting effects relating to how the home country treats the foreign income of its resident companies, the benefit to income shifting equals the difference in tax rates, and the greater the difference in rates, the greater the incentive to shift income.<sup>10</sup>

Income shifting can occur in many ways. For example, an MNE may shift income to its low-tax subsidiary by charging it a low price for internal transfers of goods, or it may shift expenses into its high-tax subsidiary by charging above market interest rates on internal loans. If transfer prices are not subject to market forces, then the resulting income distribution may not reflect each entity's "true" income.<sup>11</sup>

Table 3 provides a simple illustration of how an integrated multinational enterprise may adjust the internal transfer price to shift income from a high tax to a low tax area. In this example, an Irish manufacturing company distributes its product through a British distributor. For simplicity, assume the Irish tax rate is 10 percent and the British tax rate is 30 percent.

In scenario (1), the British distributor is independent and in scenario (2) the British distributor is a controlled subsidiary of the Irish manufacturing company. With the relatively high tax rate in the UK, the newly-integrated multinational enterprise has the incentive to shift income from the UK to Ireland to reduce its total tax payments and, therefore, increase its total after-tax profits.

As discussed earlier, if the UK subsidiary operated as an independent entity, then it would focus on maximizing its separate profits and scenario (1)

Table 3. Illustration of cross-border income shifting

(1) **No profit shifting.** Irish manufacturing company sells goods to independent distributors in the United Kingdom. (figures are in £000)

Irish manufacturing company		Independent British distributor	
Sales	£50,000	Sales	£100,000
Cost of materials	(10,000)		
Cost of manufacture	(20,000)	Cost of sales	(50,000)
Gross profit	20,000	Gross profit	50,000
		Distribution	(35,000)
Administration	(5,000)	Administration	(5,000)
Pre-tax profit	15,000	Pre-tax profit	10,000
Tax (10%)	(1,500)	Tax (30%)	(3,000)
	=====		=====
Profit after tax	13,500	Profit after tax	7,000

(2) **Profit shifting.** Irish manufacturing company increases the internal transfer price to its wholly-owned British distribution subsidiary

Irish manufacturing company		British distribution subsidiary	
Sales	£58,000	Sales	£100,000
Cost of materials	(10,000)		
Cost of manufacture	(20,000)	Cost of sales	(58,000)
Gross profit	28,000	Gross profit	42,000
		Distribution	(35,000)
Administration	(5,000)	Administration	(5,000)
Pre-tax profit	23,000	Pre-tax profit	2,000
Tax (10%)	(2,300)	Tax (30%)	(600)
	=====		=====
Profit after tax	20,700	Profit after tax	1,400

Summary	Scenario (1)	Scenario (2)
Total profit before tax	25,000	25,000
Total tax payments	4,500	2,900
Total profit after tax	20,500	22,100

*Note:* This example is modified from example INTM460160 in the U.K. Inland Revenue International Manual. See Inland Revenue (2005).

would continue to represent the “independent entity” outcome. However, if the subsidiary no longer operates as an independent entity, then its objective now forms part of the multinational’s overall objective of maximizing the group’s profits, rather than its separate entity profits. The outcome in scenario (2) no

longer represents the outcome independent entities would have reached since the independent British distributor had £7,000 after-tax profits, but the controlled distributor has just £1,400 after-tax profits.

The UK government is concerned about the tax base reduction that occurs within the multinational company in scenario (2). In accordance with the arm's length principle, the UK government may re-adjust the company's accounts to reflect the result that independent parties would have reached. To avoid double taxation, the Irish competent authority then makes a corresponding (or, correlative) adjustment in the profits attributed to the Irish manufacturing company. The agreement among countries to apply the arm's length principle generally provides a basis for tax authorities to reach these agreements and, therefore, eliminate the double taxation that might otherwise arise. If the Irish competent authority, however, does not agree with the profit adjustment, the multinational enterprise may suffer double taxation.<sup>12</sup>

### *Evidence of income shifting*

Table 3 provides evidence that income shifting may occur in theory. This section shows how income shifting occurs in practice.

The empirical evidence suggests that governments may not always be able to prevent improper income shifting. Using tax data for U.S. multinational companies, Newlon (2000) finds patterns of reported profitability and taxation that are consistent with income shifting. For example, foreign-controlled companies report lower taxable income as a share of assets or sales than their U.S.-controlled counterparts. Likewise, the reported profits of the foreign subsidiaries of U.S. multinationals are negatively related to the effective tax rate foreign operations face. Newlon cautions, however, that although the data may suggest income shifting, they also may mask important differences in the underlying companies and that a more rigorous statistical analysis is necessary to control for these differences.

Econometric studies that control for these underlying differences provide some evidence that multinational companies engage in profit shifting, although generally not to the extent suggested by the data described above. Grubert, Goodspeed, and Swenson (1993) and Grubert (1997), for example, examine the tax returns of U.S.-controlled and foreign-controlled U.S. companies and find that non-tax reasons, such as company age, industry, and exchange rates, explain a majority of the differences between the reported profits of these two groups of companies. The remaining differences in profitability may be due to income shifting or to other unobservable factors. Clausing (2003) presents evidence suggesting that corporate tax avoidance reduces government revenues from the corporate income tax. In a study using European data, Bartelsman and Beetsma (2003) find that revenues do not increase when countries raise their tax rates because reported profits fall. Altshuler and Goodspeed (2002) find that European countries engage in a tax rate competition. Grubert (2003) finds



that subsidiaries of U.S. multinational companies located in high or low tax areas that have a strong incentive to shift income also have a significantly larger volume of intercompany transactions.

To summarize, the increased volume of cross-border investment in the European Union coupled with the greater transfer pricing enforcement efforts, has made EU businesses aware of the tax obstacle created by the transfer pricing process. From the tax authorities' view, multinational enterprises appear increasingly able to shift income inappropriately to low-tax areas, and the empirical evidence suggests that multinational enterprises do take advantage of cross-border tax differentials to shift income.

These economic forces are not the only forces pressuring Member States to adjust their company tax practices. Political and judicial forces are playing a growing role in shaping Member State company tax policy.

## **2.3 CREATING A SINGLE MARKET IN THE EUROPEAN UNION**

The evolution in Europe from a number of independent countries to an integrated union of Member States helps explain the European Commission's motivation in proposing a comprehensive new direction in company taxation. The process of creating the Single European Market is not complete, yet the changes brought about by the elimination of barriers to cross-border investment have significantly affected how EU multinationals do business in the EU and how Member States tax EU multinationals.

The EU exerted its strongest efforts to create a Single Market thirty years after signing the Treaty of Rome when the then twelve Member States adopted the Single European Act (SEA). Through the SEA, the Member States established the goal of creating a Single Market without internal frontiers by the end of 1992. The Treaty on European Union, which came into force in 1993, further stimulated these efforts by creating a common economic and monetary policy.

Although it provided numerous measures to eliminate tax barriers to cross-border investment in the Internal Market, the SEA did not mandate company tax harmonization. Instead, it maintained the unanimity principle for company tax measures. The EU Member States have consistently rejected moves that would limit their ability to set company tax policy, regardless of any potential estimated benefits from company tax harmonization.<sup>13</sup>

The more recent "enhanced cooperation" procedure loosens the binding constraint imposed by the unanimity requirement in the company tax area. Under enhanced cooperation, a group of at least eight Member States may agree to take a policy forward, as long as this cooperation does not discriminate against non-participating Member States and does not undermine the economic cohesion of the internal market. Non-participating Member States may not im-

pede implementation of the cooperative measures in the participating Member States.

The European Commission has the sole right to propose Community legislation, and it takes the leading role in proposing EU-level tax policy measures, but the Member States must approve these proposals. Apart from a few Directives and related measures, the Member States have rarely approved the Commission's company tax proposals.<sup>14</sup>

This rejection has many explanations, but it may primarily be due to the Member States' view that retaining complete autonomy to set company tax policy is paramount. Member States do not feel compelled to create an EU-level company tax system

Despite the unanimity principle and reluctance to undertake company tax reform at the EU level, the Member States have taken action in the general realm of company tax reform in one important area. Perhaps more than any other European Commission initiative, the Code of Conduct on Business Taxation that the EU Member States adopted as part of the Tax Package in 1997 is causing some convergence in company tax bases across the European Union. Through the Code of Conduct, Member States must eliminate their potentially harmful preferential tax practices. In also complying with state aid rules, Member States are eliminating many measures that cause company tax bases to diverge across Member States.

Despite these actions to eliminate specific harmful preferential tax regimes, however, the Member States have not yet focused on the importance of creating an EU-level company tax system. Each Member State continues to view its company tax objectives essentially in isolation from the objectives of the European Union as a whole.

## **2.4 INFLUENCES FROM THE EUROPEAN COURT OF JUSTICE**

Recent actions from the European Court of Justice (ECJ), however, are forcing the Member States to take a broader look at how their company tax policies may be affecting the welfare of the European Union as a whole. The European Court of Justice is putting increasing pressure on the Member States to bring their company practices in line with their obligations under the EU Treaty.

Although the Member States may not yet agree, EU businesses feel that it is imperative to eliminate the measures in Member State company tax systems that hinder cross-border expansion in the European Union. The failure of the EU Member States to eliminate perceived discriminatory features of their company tax laws, combined with the inability of the European Commission to push through EU company tax reforms, has forced EU companies to turn to

Table 4. Selected European Court of Justice direct tax cases

Year	Case	Name	Issue
1986	C-270/83	<i>Commission v. France (Avoir Fiscal)</i>	Imputation tax credit
1992	C-204/90	<i>Bachmann</i>	Taxation of workers;
	C-300/90	<i>Commission v. Belgium</i>	deductibility of insurance payments
1995	C-279/93	<i>Schumacker</i>	Taxation of workers
1997	C-28/95	<i>Leur-Bloem</i>	Tax avoidance
1997	C-250/95	<i>Futura Participations</i>	Cross-Border loss compensation
1998	C-264/96	<i>ICI v. Colmer</i>	Group/consortium relief
1999	C-307/97	<i>Saint-Gobain</i>	Treatment of branches
1999	C-200/98	<i>X AB and Y AB</i>	Domestic losses
2000	C-35/98	<i>Verkooijen</i>	Dividend exemption
2000	C-141/99	<i>AMID</i>	Cross border losses
2001	C-294/99	<i>Athinaiki</i>	Tax on distribution deemed a withholding tax
2001	C-397/98	<i>Metallgesellschaft</i>	Taxation of group income;
	C-410/98	<i>Hoechst</i>	Advance corporation tax
2002	C-324/00	<i>Lankhorst-Hohorst</i>	Thin capitalization
2003	C-168/01	<i>Bosal Holding BV</i>	Participation exemption; Parent/subsidiary Directive
2004	C-315-02	<i>Lenz</i>	Foreign dividends
2004	C-319/02	<i>Manninen</i>	Cross-border dividend imputation credit
Pending	C-446/03	<i>Marks &amp; Spencer</i>	Group relief; cross-border loss compensation
Pending	C-196/04	<i>Cadbury Schweppes</i>	Anti-deferral and controlled foreign corporation regimes
Pending	C-492/04	<i>Lasertec</i>	Thin capitalization and non-EU countries

Source: European Commission (2005a).

the ECJ for relief. As a result, the European Court of Justice has effectively joined (some might say it has replaced) the European Commission in shaping EU company tax policy.

The ECJ's influence stems, in part, from the fact that it treats the European Union as a single jurisdiction rather than as a collection of individual Member States.<sup>15</sup> As a result, the Court tends to focus on determining whether an EU Member State's tax policies violate the fundamental freedoms in the EU Treaty.

Although the ECJ has always had this role, its actions are relatively recent, as it was not until 1986 in the *Avoir Fiscal* case that the ECJ issued its first major decision in the company tax area. In this case, the Court ruled that aspects of the French dividend imputation system violated the Treaty. Table 4 lists some key European Court of Justice decisions in direct taxation.

Many of the tax policies that the ECJ finds incompatible with the EU Treaty form a long-standing part of Member State company tax policies. These policies fall in the area of dividend imputation systems, rules restricting deductions for debt financing (thin capitalization rules), group relief provisions and cross-border loss compensation, exit taxes, and anti-deferral (controlled foreign corporation) measures.

The *Marks & Spencer* case illustrates one critical aspect of the problem. Marks & Spencer, plc, a U.K. corporation, incurred losses in the German, Belgian and French subsidiaries it held indirectly through a Dutch holding company. These subsidiaries had no economic activity in the United Kingdom.

Marks & Spencer claimed that it was entitled to offset the losses incurred by these subsidiaries against its U.K. taxable profits for the corresponding tax years. Under the United Kingdom's group relief provisions, however, a company may offset domestic profits with losses from foreign branches but not with losses from foreign subsidiaries. Marks & Spencer argued that by denying relief for losses in its EU subsidiaries, the U.K. tax legislation made it less attractive to establish subsidiaries in other Member States.

In April 2005, ECJ Advocate General Miguel Poiares Maduro issued an opinion supporting Marks & Spencer. He found that the U.K. law created an obstacle to cross-border investment and, thus, violated the Treaty's freedom of establishment provisions.<sup>16</sup>

The basic thrust of these decisions is clear: EU Member States have the right to set their own company tax policies, but they may not interfere with the Treaty's fundamental freedoms, particularly with the freedom of establishment. Member States may not discriminate against cross-border activity. Member States may not favor domestic investment over foreign investment. Member States may not restrict companies from establishing operations in another Member State.

The cumulative impact of these decisions is that Member States have de facto lost their sovereignty to set company tax policy independent of how those policies affect the functioning of the Single Market. As Advocate General Poiares Maduro noted:

"There is no doubt that the Member States as a matter of principle retain extensive competences in tax matters. However, they can no longer disregard the constraints imposed on their activities. They must endeavor to ensure that the choices made in tax matters take due account of the consequences which may flow therefrom for the proper functioning of the internal market."

The Advocate General all but called for action at the EU level. He concludes his opinion by noting that "it is not for the Court to determine a uniform scheme for all the Member States, basing its model on one national tax system or another or on a proposal that may be adopted by the Community institutions."

The ECJ is having a positive impact by removing cross-border tax obstacles in the European Union one by one. This process is a slow, but steady, way to eliminate the barriers to cross-border investment in the EU. However, this process may lead to 25 different ways of eliminating these tax barriers. For example, in response to the *Lankhorst-Hohorst* decision, Germany extended its thin capitalization rules to apply to domestic and foreign affiliates. Spain pursued the opposite course and extended its domestic exemption to the EU.

Taken individually, each Member State's policy may be compatible with the EU Treaty. But, taken as a whole, the collective impact of these policies may not help the EU meet its objective of becoming the "most competitive and dynamic knowledge-based economy in the world."<sup>17</sup>

## **2.5 COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP**

The European Commission recognizes the importance of taking positive action in this area. It laid the foundation for implementing its company tax strategy in September 2004 when the Commission gained approval from a large majority of the Member States to pursue its short-term and long-term goals. The Commission then established the Common Consolidated Corporate Tax Base Working Group (CCCTB WG) as the forum for work on the common EU-level tax base.<sup>18</sup>

The Working Group will seek first to define the rules for calculating a common tax base without consolidation. These rules include structural elements of the tax base, such as rules governing depreciation, inventory valuation, treatment of expenses, and inter-company dividends.

The Working Group will then focus on additional issues relating to creating a common tax base with consolidation. These issues include the method of consolidation, the treatment of profits and losses, and the legal and administrative framework. Other important areas the Group will discuss include whether the entire scheme should be optional or whether individual elements of the tax base may be optional.

The Commission notes that devising an appropriate "apportionment mechanism" to distribute the tax base to the Member States forms a critical part of the comprehensive tax reform. Work on the apportionment mechanism will proceed simultaneously with work on the tax base, although the Commission has not yet established a formal means to take this work forward.<sup>19</sup>

The goal of the next three chapters is to advance that process by evaluating how formulaary apportionment may operate in the European Union. Chapter 3 explains how formulaary apportionment works. Chapter 4 evaluates issues concerning how to choose the factors for distributing the tax base across the Member States. Chapter 5 addresses related issues concerning the taxable connection, the tax base, and the taxable group.

## Notes

1. Belgium, the Netherlands, Luxembourg, France, Germany and Italy signed the Treaty establishing the European Economic Community in Rome in 1957. For the latest version of the EU Treaty, see the *Official Journal of the European Communities*, C 325/33, 24 December 2002. The European Community became known as the European Union through the Maastricht Treaty on European Union in 1993.

2. See Gorter and de Mooij (2001).

3. See European Commission (2000).

4. Member States take into account other countries' tax systems through their bilateral tax treaties and in methods adopted to alleviate double taxation.

5. Austria and Italy adopted worldwide consolidation after the Commission released its study. France also offers worldwide consolidation, but in extremely limited cases.

6. As stated in the OECD Transfer Pricing Guidelines (1995), Article 9(1) of the OECD Model Tax Convention provides the authoritative statement of the arm's length principle. Article 9(1) provides that in the case of associated enterprises "[When] conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

7. Although transfer pricing is typically viewed as an issue concerning cross-border transfers, some EU Member States require companies to apply the transfer pricing rules and regulations to solely domestic transactions. For example, as of 2005, Danish companies must comply with the disclosure and documentation requirements for transactions between Danish companies. Since 2004, the United Kingdom has required UK companies to comply with the transfer pricing rules for intercompany transactions between UK resident companies.

8. The United Kingdom may be an exception. According to the UK Inland Revenue (2005), transfer pricing manipulation had started to be a concern before the First World War and "remedial legislation" was first attempted in 1915, but the UK did not enact transfer pricing legislation (which later became ICTA88/S770) until 1951. By contrast, in 1928 the United States incorporated the predecessor to current Internal Revenue Code section 482 (as Section 45). See U.S. Department of the Treasury (1988). In 1939, the Department of Finance in Canada passed transfer pricing legislation as Section 23B of the 1939 Income Tax Act, although it was not until 1972 that Canada adopted arm's length pricing (Section 69) as part of the Tax Reform Package and not until 1976 that transfer pricing issues first became a major concern in Canada. For details on the Canadian history, see Eden, Dacin, and Wan (2001). The fact that a country has arm's length pricing rules and regulations, however, does not mean that the tax authorities enforce their legislation to the same degree. There is no doubt that the United States is in the forefront in enforcing the transfer pricing rules.

9. This "relaxed" attitude may exist in Ireland, where only a minority of Irish respondents believes that tax revenue authorities are paying increased attention to transfer pricing issues. Of course, with the low tax rate in Ireland, the Irish tax base is less vulnerable to income shifting than are the tax bases in countries that have higher tax rates. The lower the tax rate, the lower the benefit to transfer pricing manipulation.

10. If the home country exempts foreign-source income, a multinational company always has an incentive to shift income to the low tax jurisdiction. If the home country applies a foreign tax credit system, then the incentive depends on the company's foreign tax credit position and the ability to defer home country taxes. Since the EU plans to limit the new tax system to the EU's territorial boundaries, it will need to address the incentive to shift income out of the EU. I am grateful to Joseph Guttentag for emphasizing the importance of the foreign income issue.

11. Not all income shifting is inappropriate or inconsistent with arm's length pricing. Companies may shift income by applying arm's length prices within the range of acceptable arm's length prices.

12. The Commission Study (2002) reports that double taxation is a serious obstacle to the Internal Market. EU companies have recourse to the EU Arbitration Convention (see 90/436/EEC) to attempt to resolve such transfer pricing disputes.

13. See Copenhagen Economics (2004) for estimates of how company tax harmonization may affect EU welfare. See Wilson (1999) for evidence showing that tax competition has both benefits and drawbacks.

14. The Member States adopted the first measures in direct company taxation in July 1990. These measures include the merger directive (90/434/EEC), the parent/subsidiary directive (90/435/EEC) and the EU Arbitration Convention (90/436/EEC). In June 2003, the Member States approved the savings directive (2003/48/EC) and the interest and royalties directive (2003/49/EC).

15. The EU Treaty grants the European Court the primary role of interpreting EU law and ensuring that the EU Member States apply the law uniformly within the Community. Provisions in the EU Treaty take precedence over Member State law.

16. See Opinion of Advocate General Pöiares Maduro delivered on 7 April 2005 in *Marks & Spencer plc. v. David Halsey (HM Inspector of Taxes)*, Case 446-03. See Sheppard (2005) and Martin (2004) for analyses of potential impacts on the Member States from the Marks & Spencer case.

17. See Lisbon European Council, 23 and 24 March 2000, Presidency conclusions.

18. For a description of the Working Group's program and objectives, see the various papers available on the website of the European Commission's Taxation and Customs Union. See [http://europa.eu.int/comm/taxation\\_customs/taxation/index\\_en.html](http://europa.eu.int/comm/taxation_customs/taxation/index_en.html).

19. In March 2004, the European Commission invited tax experts from the academic world to a Workshop to examine details of a potential apportionment formula. The participants did not make any specific recommendations, but they came to consensus on some points. First, it is necessary to define clear criteria for evaluating an appropriate apportionment mechanism, and it is necessary to balance economic rationale with political acceptability. The participants preferred a formula based on a firm's particular characteristics to a formula based on macroeconomic factors, and they agreed that the system should be limited to the European Union's territorial borders, that is, to the EU water's edge.

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