

B. Common Corporate (Consolidated) Tax Base: Some Institutional Details

The current initiatives of the European Commission are based on the 2001 report “Company Taxation in the Internal Market”.⁹ The Commission believes that only a comprehensive solution is suitable to eliminate tax obstacles in the EU systematically. The long-term objective in removing tax obstacles to cross-border business activities is the introduction of a CCCTB for the EU-wide activities of multinationals. In short, the proposed CCCTB would imply a three-step approach:

- (1) Determination of corporate taxable income of group members based on a harmonised set of tax accounting regulations; (Articles 9 – 43);
- (2) Consolidation of the individual, i.e. the group members’, corporate tax bases to the common tax base (Articles 54 – 60);
- (3) Allocation of the consolidated tax base to group members located in different Member States by formula apportionment (Articles 86 – 103).

The proposed CCCTB would, however, neither interfere with financial accounting regulations nor would it harmonise tax rates. Consequently, each Member State would maintain its national rules on financial accounting and preserve its right to tax the allocated portion of the consolidated tax base at the level of each group member applying its own national corporate tax rate. Tax competition based on national corporate tax rates within the EU is explicitly encouraged by a CCCTB.

The proposed Council Directive applies to so-called eligible EU companies. A eligible company must take one of the forms listed in Annex I to the proposed Council Directive and must be subject to corporate taxation in a Member State as listed in Annex II (Article 2). Yet, it should be noted that the proposed CCCTB would be an optional rather than a mandatory system. Companies would, therefore, have the option to remain fully governed by the national tax system or to be taxed under the proposed CCCTB (Article 6). Consequently, Member States would have to administer two corporate tax systems at the same time. The option to apply the proposed CCCTB would be valid for an initial period of five tax years, which could be extended for successive terms of three tax years, unless notice of termination is given (Article 105). Companies that opt for the proposed CCCTB system would only file a single tax return with the so-called principal tax authority in one Member State (one-stop-shop system) for the group’s entire activities in the EU (Article 109). Thus, all communication would take place solely between the principal taxpayer of the group and the tax authority to which it is assigned. Furthermore, when the option to apply the proposed CCCTB is exercised all qualifying subsidiaries are automatically consolidated (the all-in, all-out principle). According to Article 54,

⁹ See Commission of the European Communities (2001).

qualifying subsidiaries include all immediate and lower-tier subsidiaries, in which the parent company holds a right to exercise more than 50% of the voting rights, an ownership amounting to more than 75% of the company's capital or more than 75% of the rights giving entitlement to profit. In general, the thresholds must be met throughout the year (Article 58).

B.1. The CCCTB: A Shift in Paradigm

The consolidation and allocation of group income to the individual group members represents a paradigm shift in corporate taxation. In order to understand how this paradigm shift is meant to work, it is helpful to consider the limits of separate entity accounting currently in practice and the aimed benefits of consolidation and formula apportionment.

Consolidating the separately determined profits of group members makes it impossible to maintain the prevailing system of direct allocation of profits using transfer prices based on the arm's length principle for individual transactions (separate entity accounting). Instead, consolidating the individual results requires an indirect division of the profits of the consolidated overall result using a formula, i.e. breaking down the group's result among the individual group companies (formula apportionment). Formula apportionment has a long tradition in North America, e.g. group taxation at the level of the States (US) or at the level of the Provinces (Canada).¹⁰ As mentioned above, the rationale for formula apportionment begins with the limits of separate entity accounting. Concerning economically integrated groups of companies, the transactional approach seems theoretically questionable. By setting up an integrated group of companies, coordination of transactions via markets is abandoned in favour of coordination using intra-organisational hierarchies. The aim is to generate economies of integration, for example by means of lower transaction costs, improvement of information flow or managerial efficiency.¹¹ As a result, the profits of an integrated group of companies are higher than the aggregate profits earned by its separate entities. Since the excess profits accrue at group level, it seems difficult to determine the source of these profits as they cannot be attributed to specific and, above all, individual transactions either. Therefore, the comparison of controlled transactions to uncontrolled transactions – as the arm's length principle implies – seems conceptually questionable and systematically inapplicable.¹² Double taxation constitutes another problem arising in the context of the arm's length principle. One tax jurisdiction may adjust a given transfer price because it is deemed not to be at arm's length. If the other jurisdiction does not agree to a corresponding adjustment, there is a risk of double taxation.¹³

Against this background, the current international tax system is inadequate with reference to the principles of efficiency and neutrality as well as simplicity and enforceability. The arm's length principle ignores the differences between control-

¹⁰ See Weiner (2005), pp. 10-15; Mintz/Weiner (2003), pp. 695-711.

¹¹ See Berry/Bradford/Hines (1992), p. 737.

¹² See McLure (1984), pp. 94, 105; Jacobs/Endres/Spengel (2011), p. 661.

¹³ See Newlon (2000), pp. 220-221.

led and uncontrolled transactions and entails the scope for abusive transfer pricing.¹⁴ It is incapable of fairly allocating profits to the countries involved according to their source and, thus inconsistent with the principle of international equity.¹⁵ At the same time, double taxation, which arises if transfer prices are adjusted unilaterally, violates the principle of equity between taxpayers.¹⁶

Under the proposed CCCTB, the arm's length principle as a means for the allocation of taxable income between jurisdictions would be replaced by formula apportionment. Formula apportionment does not seek to allocate income to its source perfectly. Rather, the rationale behind formula apportionment is to provide a pragmatic solution for profit allocation among jurisdictions in order to better cope with the issues of simplicity and enforceability. Yet, formula apportionment is not arbitrary. Depending on the choice of apportionment factors, this approach intends to allocate the consolidated tax base to the profit generating activities. Factors which are deemed to represent profit generating activities under the proposed CCCTB are sales, payroll, number of employees and the assets of the company. Considering a company, A, which belongs to a group of companies being taxed under the proposed CCCTB, the apportionment formula thus reads as follows (Article 86):

$$Share_A = \left[\frac{1}{3} \times \frac{Sales_A}{Sales_{Group}} + \frac{1}{3} \times \left(\frac{1}{2} \times \frac{Payroll_A}{Payroll_{Group}} + \frac{1}{2} \times \frac{Employees_A}{Employees_{Group}} \right) + \frac{1}{3} \times \frac{Assets_A}{Assets_{Group}} \right] \times CTB$$

with *CTB* representing the consolidated overall result of the group.¹⁷

At this point, it may be helpful to consider a simplified example in order to understand the tax implications of the sharing mechanism. Consider a group that consists of company A and company B. Company A resides and sells its output in Member State X and company B resides and sell its output in Member States Y. Required information regarding sales, payroll, employees and assets for both companies are provided in [Table 1](#).

¹⁴ See Avi-Yonah/Benshalom (2011).

¹⁵ See Jacobs/Spengel/Schäfer (2004), pp. 272-273.

¹⁶ See Li (2002), p. 840.

¹⁷ For the composition and other details on the sales, labour and asset factor see Article 90-97 of the proposed Council Directive. For another example of the application of formula apportionment, see Fuest (2008), pp. 724-725.

Table 1: Example for the Application of Formula Apportionment

Country		Member State X	Member State Y
Company A	Sales	40	
	Payroll and Employees	40	
	Assets	40	
	Taxable Income	30	
Company B	Sales		80
	Payroll and Employees		20
	Assets		20
	Taxable Income		60
Tax Rate		10%	30%

Considering the given information above, the tax burden under separate accounting per company and the total tax burden for the group amounts to 21:

$$T_A = 30 \times 0.1 = 3; \quad T_B = 60 \times 0.3 = 18; \quad T_A + T_B = 3 + 18 = 21$$

Applying the apportionment formula according to Article 86 and assuming an identical tax base, the tax burden per company and the total tax burden for the group amounts to 17:

$$T_A = 0.1 \times (30 + 60) \times \left(\frac{1}{3} \times \frac{40}{120} + \frac{1}{3} \times \frac{40}{60} + \frac{1}{3} \times \frac{40}{60} \right) = 5$$

$$T_B = 0.3 \times (30 + 60) \times \left(\frac{1}{3} \times \frac{80}{120} + \frac{1}{3} \times \frac{20}{60} + \frac{1}{3} \times \frac{20}{60} \right) = 12$$

$$T_A + T_B = 5 + 12 = 17$$

The simple example illustrates that formula apportionment would significantly change the total tax burden for groups of companies and may provide incentives to increase EU-wide tax rate competition. Obviously, the tax implications depend on the relation of the apportionment factors and on the tax rates stipulated by the Member States.

As the Commission recognises that applying the general formula may lead to unfair or inappropriate results, Article 87 provides a safeguard clause allowing the taxpayer or the authority concerned to request the use of an alternative method. Furthermore, Articles 98 – 101 provide variations of the general formula for specific sectors, e.g. financial institutions, transport or insurance undertakings.

B.2. Advantages: Overcoming Tax Obstacles to Cross-Border Activities

The main objective stressed in the proposed Council Directive is to tackle major fiscal impediments to growth in the Single Market that are caused by the interaction of 27 different national tax systems. The proposed CCCTB is expected to con-

tribute to the elimination of tax obstacles to cross-border EU-wide activities in several ways. Namely, the CCCTB is to solve the problem of double-taxation as a result of conflicting taxing rights, reduce compliance and administrative costs and remove distortions caused by limitations of cross-border loss relief and reorganisations within the EU. Table 2 summarises some of the major objectives and illustrates whether the proposed CCCTB is capable to overcome the existing obstacles to cross-border activities in the EU. As the Commission should also consider a strategy that would introduce the CCCTB in two steps if there is no unanimous support among the Member States, Table 2 also lists the achievements realised under a CCTB.¹⁸

Table 2: Reduction / Elimination of Tax Obstacles to Cross-Border EU-Wide Activities by the CC(C)TB

Reduction / Elimination of Tax Obstacles to Cross-border Activities	Approaches with Different Degree of International Cooperation	
	Common Corporate Tax Base throughout the EU (CCTB)	Common Corporate Consolidated Tax Base throughout the EU (CCCTB)
Compliance Costs	Achieved	Achieved
Cross-border Loss Relief	Not achieved, but simplified Except to the extent that Member States already provide cross-border loss relief	Achieved
Transfer Prices	Not achieved, but simplified Transfer prices are still required for the allocation of the tax base	Achieved Transfer prices are substituted by formula apportionment
Reorganisations	Not achieved, but simplified Only if the tax treatment of reorganisations is harmonised	Achieved Only if the tax treatment of reorganisations is harmonised
Double Taxation as a Result of Conflicting Taxation Rights	Not achieved	Achieved

As displayed in Table 2, the proposed CCCTB has to be established in order to fully eliminate tax obstacles to cross-border activities within the EU. First, with the introduction of the proposed CCCTB many forms of profit shifting through transfer pricing disappear among companies participating in the CCCTB. Further benefits lie in consolidating taxable profits: The consolidation of the individual results of the group members yields cross-border loss compensation at the level of the taxable entity. Furthermore, supplies and services may generally be invoiced at the respective tax book value as only profits realised from transactions with third parties are distributed among the group companies by the allocation of profits. This

¹⁸ For the following, see also Spengel (2008), Spengel/Wendt (2008) and Spengel/Malke (2009).

eliminates inter-company profits taking the single economic unit argument into account. Moreover, the group's tax burden cannot be influenced by changing intra-group financing, so that measures to limit shareholder debt financing (thin-capitalisation rules) and CFC regulations – at least within countries participating in the CCCTB – would become obsolete.¹⁹ Furthermore, costs for refinancing are deducted from the consolidated group income and apportioned to all Member States in which group members are resident rather than from individual income. Finally, hidden reserves upon cross-border reorganisations or the transfer of assets do not have to be taxed immediately; they are divided among the group members according to the allocation formula upon realisation, irrespective of where the profits are generated. Formula apportionment thus abolishes the incentives to transfer book profits from one group member to another. To this extent, the proposed CCCTB takes away most of the companies' tax-planning opportunities but, on the other hand, abolishes obstacles to cross-border business activities, reduces Member States' conflicts with EU-law and increases the Member States' tax autonomy.

In the case of a CCTB, merely a harmonised set of tax accounting regulations for the determination of corporate taxable income would be applied across Member States. Even though a CCTB would obviously give rise to new challenges for both, tax authorities and companies²⁰, the CCTB is likely to reduce compliance and administrative costs.²¹ In contrast, all other tax obstacles on cross-border activities identified above would generally remain. A closer look, however, reveals several important advancements: First, a CCTB is a prerequisite for any form of cross-border loss relief within the EU. Without harmonisation of the tax base, separate accounting rules for the determination of foreign losses – with all the attendant difficulties associated with the recapture of loss relief if the foreign subsidiary claims its own relief later – have to be maintained. Second, although transfer pricing would obviously remain an issue under a CCTB system, both tax authorities and companies would benefit from harmonised tax accounting regulations in several ways. Most obviously, given that transfer prices are usually calculated in accordance with (tax) accounting principles for the purpose of applying cost-based methods (e.g. the cost plus method), difficulties associated with determining the cost base for cross-border transactions in the same manner would become much more manageable. Finally, a harmonised corporate tax base clearly facilitates cross-border reorganisation and international cooperation between Member States. As assets and liabilities would be recognised and measured under the identical set of regulations in all Member States, adopting a system of a CCTB would reduce many of the uncertainties, administrative burdens and threats of double taxation in cross-border reorganisations.

¹⁹ Please note that the proposed Council Directive provide both CFC-Rules (Article 82 and 83) as well as thin-capitalisation rules (Article 81). Yet, it should be noted that the regulations laid down in Articles 81 to 83 are more or less relevant only to associated enterprises resident in a third-country.

²⁰ Most important, tax authorities will have to administer two corporate tax systems instead of one if the CC(C)TB – as proposed by the Commission – is optional.

²¹ See also Schreiber (2009), p. 91.

To conclude, while only the proposed CCCTB would eliminate or at least reduce major tax obstacles to cross-border activities in the EU, the introduction of a mere CCTB, i.e. a CCCTB without consolidation and formula apportionment, would also offer benefits to both tax authorities and companies. As it avoids many of the technical challenges and difficult issues raised by the proposed CCCTB - some of which will be discussed below - the CCTB appears to be a promising starting-point for corporate tax harmonisation in the EU.

B.3. Implementation Issues: Some Critical Comments

As already mentioned above, the proposed Council Directive raises a number of difficulties, new issues and technical challenges. Important examples include the entry and exit rules referring to the taxation of hidden reserves or questions regarding a minimum corporate tax rate. Hence, in this subchapter, we discuss some issues and obstacles on the way to the proposed CCCTB, including some general issues, e.g. the administration of the CCCTB or the treatment of third country in- and outbound investment, questions arising in the context of tax planning and issues of transition, i.e. the entry to and the exit from the proposed CCCTB. All issues discussed reveal more or less unsolved problems arising from introducing a consolidation and sharing mechanism and make a good case for the European Commission to consider the strategy of introducing the CCCTB in a two-step approach. Again, the first step would introduce a harmonised set of tax accounting rules at the level of each company. These tax accounting rules could be applied to group members as well as to individual companies. Under a CCCTB there is no obvious reason why it should be denied to individual companies. The second step then would introduce consolidation and formula apportionment at a later stage.

Formula Apportionment: Some General Issues

a.) Factors in the Formula: Intangibles

As noted above, factors which are deemed to represent profit generating activities under the proposed CCCTB are sales, payroll, the number of employees and the fixed assets of the company. In contrast, intangible assets are excluded from the asset factor under the current scope of the proposal (Article 92). Yet, intangible assets constitute an important part of the total asset and the economic presence of multinationals.²² In this regard, a key issue that arises is whether the exclusion of intangibles yields inappropriate and unfair results as unduly low shares of the common tax base would be allocated to those group members developing intangibles.²³ Obviously, the European Commission has considered this issue but faces a trade-off: On the one hand, intangible assets clearly constitute a substantial factor in the value chain and, therefore, should be included in the measures of assets. On the other hand, it is inherently difficult to measure

²² See McLure/Weiner (2000), p. 269.

²³ For a detailed discussion on formula apportionment and the role of intangible assets, see Avi-Yonah/Benshalom (2011).

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