The Common Consolidated Corporate Tax Base

By

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*Prepared for the Tax Conference "Corporation Tax: Battling with the Boundaries", June 28th and 29th, 2007, Said Business School, Oxford.

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1 Introduction: purpose of the paper

This paper summarises the main topics that were discussed at the International Tax Conference on the Common Consolidated Corporate Tax Base which took place in Berlin on May 15th and 16th, 2007.[1] First, it highlights the major tax obstacles to EU-wide economic activities. Second, it analyses different options for implementing a common tax base in the EU. Third, it deals with the most important implementation issues of a common tax base that were discussed at the conference in Berlin. Fourth, it includes some additional considerations on tax rates in case of a common tax base. The most important findings are summarised at the end.

2 Tax obstacles to EU-wide economic activities

Company taxation in the EU reveals a great diversity. This refers to the tax rates and tax bases as well as to corporation tax systems and local taxes. The taxation of cross-border investments is based on the coexistence of the source and residence principle.

Austria	25	Latvia	15
Belgium	34	Lithuania	15
Bulgaria	10	Luxembourg	29.6
Cyprus	10	Malta	35
Czech Republic	24	Netherlands	25.5
Denmark	28	Poland	19
Estonia	0	Portugal	27.5
Finland	26	Romania	16
France	34.4	Slovakia	19
Germany	38.7	Slovenia	23
Greece	25	Spain	32.5
Hungary	17.5	Sweden	28
Ireland	12.5	United Kingdom	30
Italy	37.3		

Table 1: Nominal tax rates on corporate profits (federal and local level, 2007, per cent)

Currently, nominal tax rates vary between 10 and 38.7 per cent (Table 1). It is well known that nominal tax rates in addition to the tax base are the decisive factor for determining the effective corporate tax burdens. This EU-wide range of **effective company tax burdens** causes several distortions with respect to cross-border activities within the EU:

(1) It affects decisions of investors with respect to the location of an investment, the type of investment and its source of finance. This violates the **fundamental economic goals of the EC Treaty** (Art. 2 EC) since no efficient allocation of resources is guaranteed.

[1] The contributions to the International Tax Conference will be published soon.

(2) The coexistence of 27 separate tax systems causes several **tax obstacles to cross-border activities within the EU**. First, the need to comply with different rules entails a considerable compliance cost and represents itself a significant tax obstacle. Moreover, since no single taxation of multinationals exists and each member state is a separate tax jurisdiction, this entails a number of further consequences. Since separate taxation in each member states prevails and with regard to cross-border investments source and residence principle coexist, double taxation may occur as a result of **conflicting taxing rights.** In particular

- relief for losses incurred by affiliated companies located in other member states is not allowed in many cases;
- the allocation of profits of multinationals to different jurisdictions using arm's length transfer prices causes methodological problems and results in double taxation;
- cross-border reorganisations give rise to capital gains taxation and bear the risks of double taxation in many situations.

(3) To **protect their tax bases** against profit shifting of multinationals **member states** introduced provisions such as the denial of cross-border loss relief, exit taxes, thin capitalisation rules, and CFC-legislation. These tax provisions may **violate the fundamental freedoms of the EC Treaty** (see ECJ-judgements, e.g. Marks & Spencer, X and Y, Lankhorst-Hohorst, Cadbury-Schweppes). Without further tax coordination member states are presumably not able to reform their tax systems so that they respect the fundamental freedoms for cross-border activities and at the same time not to destroy the systems of domestic company taxation.

3 Options for a common tax base in the EU

At first glance, a **harmonised corporate tax rate** could be a step forward. Since the impact of the tax bases on the effective tax burdens as well as member states conflicting taxing rights would remain, however, this is not the way to success.

Only a comprehensive solution can help to eliminate tax obstacles systematically. The European Commission has proposed a **Common Consolidated Corporate Tax Base (CCCTB)** for the EU-wide activities of multinationals. A proposal for a directive should be released till the end of 2008. According to the concept of the CCCTB three distinct steps are necessary to arrive at the tax base for each jurisdiction:

(1) Each group member calculates its taxable profits separately but according to the same set of rules;

(2) The individual tax bases are aggregated to the consolidated tax base;

(3) The consolidated tax base is allocated to the different member states by applying specific factors (formula apportionment).

Finally, each member state preserves its right to tax the allocated portion of the consolidated tax base applying its own tax rate. As taxation at the level of each group member is supposed to be final, the CCCTB promotes the source principle with regard to the taxation of cross-border investments.

Although there is strong support for the idea of a CCCTB, it is, however, not clear whether such a harmonised tax base really corresponds to the original idea of a CCCTB. Three different interpretations of a harmonised tax base exist, each of which involves a different degree of mutual cooperation and each of which eliminates tax obstacles to cross-border EU-wide activities to a different extent (Table 2).

	Approaches to EU company taxation with different degree of international cooperation		
Reduction / elimination of tax obstacles to cross-border EU-wide activities	**- Harmonised tax base throughout the EU with one set of tax accounting principles**	**- Harmonised tax base throughout the EU with one set of tax accounting principles** **- Cross-border loss relief**	**- Harmonised tax base throughout the EU with one set of tax accounting principles** **- Consolidation (including elimination of inter-company profits)** **- Allocation of the consolidated tax base**
Compliance costs	Achieved	Achieved	Achieved
Cross-border loss relief	Not achieved Except to the extent that member states already provide cross-border loss relief	Achieved	Achieved
Transfer prices	Not achieved Transfer prices are still required for the division of the tax base	Not achieved Transfer prices are still required for the division of the tax base	Achieved Transfer prices are substituted by formula apportionment
Reorganisations	Achieved But only if the tax treatment of reorganisations is harmonised	Achieved But only if the tax treatment of reorganisations is harmonised	Achieved But only if the tax treatment of reorganisations is harmonised
Double taxation as a result of conflicting taxing rights	Not achieved	Not achieved	Achieved

Table 2: Approaches to EU company taxation

(1) The minimum degree is a **harmonised tax base** which should be based on a single set of tax accounting principles. Clearly, such a model would reduce compliance costs. However, all other tax obstacles on cross-border activities would remain.

(2) A **harmonised tax base** is a prerequisite for **cross-border loss relief**. Otherwise, there would have to be 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 loss relief locally later. Some mechanism is necessary to prevent that loss relief is claimed more than once, as was emphasised in an earlier proposal for foreign loss relief by the European Commission.

(3) In order to fully eliminate tax obstacles to cross-border EU-wide activities (compliance costs, group-wide consolidation of profits and losses, transfer pricing problems, simplification of cross-border reorganisations, overcome double taxation caused by conflicting taxing rights) a **consolidated tax base** has to be established. In the event of consolidation, the allocation of the total taxable profits of the group can no longer be based on transfer prices. Instead, some kind of allocation mechanism is necessary to allocate the overall tax base to the different member states involved.

4 Implementation issues

A CCCBT raises several implementation issues. They cover the determination of taxable income at the level of each group member, the determination of group income (consolidation), the apportionment of group income and some related issues.[2]

(1) With regard to the **determination of taxable income** there is strong support to accept International Financial Reporting Standards (IFRS) as a starting point for the common tax base. Since several elements of taxable income are not addressed in financial accounting, common rules for loss-compensation as well as the taxation of capital gains and dividends have to be developed.

(2) Concerning the **determination of group income (consolidation)**, it is first necessary to define the taxable group. The definition of the group should combine legal (e.g. ownership) and economic (e.g. economic integration of group members) criteria. The concept of residence based on OECD principles is well established and should be maintained. In order to avoid that the harmonisation of corporate taxation affects the personal income tax, the CCCTB should be restricted to corporations at the European level. Each member state could then, however, decide whether to grant partnerships access to the CCCTB. Second, the scope

[2] A personal view how to deal with this implementation issues is provided in the paper "A Common Consolidated Tax Base for Multinational Companies in the European Union" (by Carsten Wendt and me) attached to this summary.

of consolidation should cover all group income consolidated on a broad basis (i.e. include all categories of income and provide a neutralisation of intra-group transactions). Third, it is necessary to define a mechanism with regard to companies and assets entering and leaving the group. Such entry and exist rules serve to secure member states taxing rights for hidden reserves build up before (entry) and during (exit) consolidation. Therefore, separate accounting rules have to be maintained in addition to formula apportionment.

(3) For the **apportionment of group income** the allocation formula should be based on a broad set of micro-factors such as proportional capital, labour costs, and turnover which must be defined uniformly across member states. Macro-factors and micro-factors, if derived from value-added, do not seem to be appropriate.

(4) **Related issues** first concern the legal obligation of a CCCTB. In order to administrate such a system, to restrict tax arbitrage and to avoid discrimination of purely domestic activities, a CCCTB should be compulsory (i.e. without option) and applied to both domestic and international companies. Second, administration should be executed by a superordinate control entity (one stop shop). Third, since local profit taxes as a general rule follow the source principle, they can be levied on the apportioned income in each member state; therefore they do not reduce the consolidated group income. None-profit taxes and social security contributions should be deducted from the apportioned income.

5 In favour of an additional minimum corporate tax rate

Formula apportionment introduces a new concept of company taxation. It operates as a direct tax on the allocation factors (i.e. on capital, labour costs, and turnover). By reallocating business functions entering the allocation formula multinationals are able to shift a greater portion of the tax base to other member states compared to the prevailing division of the tax base applying transfer prices. Such a reallocation is promoted by a CCCBT since the transfer of functions is no taxable event due to the elimination of inter-company profits. Given the considerable EU-wide range of nominal tax rates, tax competition within the EU presumably will increase (tax rate differentials in the EU are by far more relevant than in Canada and the USA).

Increasing tax competition might provoke member states to further tax cuts on corporate profits. Moreover, it worsens the proper functioning of the Common Market if decisions where to locate investments are mainly tax driven. This inevitably raises the question whether a CCCTB should be combined with a minimum tax rate on corporate profits. A minimum corporate tax rate has two objectives: it protects an efficient allocation of resources and thus, the

economic goals of the EC Treaty. Moreover, it protects the autonomy of member states with respect to the personal income tax. Therefore, a harmonised tax base combined with a minimum corporate tax rate serves as a compromise between economic efficiency in the EU and member states tax autonomy.

6 Conclusion

A CCCTB helps to reduce current tax obstacles to cross-border activities within the EU. For the implementation of a CCCTB, it is necessary to introduce harmonised rules for the determination of taxable income as well as for the consolidation and the allocation of group income. Moreover, a CCCBT can only reach its objectives if it is accompanied by a minimum corporate tax rate. Therefore, the idea of a CCCBT is very far reaching. Member states have to balance the need for harmonisation against the current problems of taxing EU multinationals. Experience from VAT with a uniform tax system and a fixed band of tax rates indicates that the allocation of the tax base to the member states is the most difficult task.

Literature

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