THE EUROPEAN COMMISSION´S PROPOSAL FOR A COMMON CONSOLIDATED CORPORATE TAX BASE

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Abstract

The European Commission currently prepares a proposal for a directive on the introduction of a Common Consolidated Corporate Tax Base (CCCTB). This paper reviews the current state of the European Commission´s preparation of the CCCTB proposal and discusses the implications for efficiency and fairness of the tax system. The analysis concludes that more evidence of significant economic benefits from introducing a CCCTB would be required to generate widespread support for the project.

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1. Introduction

The publication of the Report on Company Taxation in the Internal Market[1] in 2001 has triggered an intensive debate on the coordination of corporate income taxation in the European Union (EU). While the Report suggested various alternatives for corporate tax coordination, the debate has now focused on the project of introducing a Common Consolidated Corporate Tax Base (CCCTB). The CCCTB would imply i) a common set of rules for the calculation of corporate profits for purposes of taxation, ii) consolidation, i.e. the determination of an EU-wide taxable profit as a basis for taxation, and iii) the apportionment of the common tax base to the member states, depending on the geographical distribution of the firm´s economic activity. Compared to the existing system, where corporations are taxed by each member country separately, using different rules for the determination of the tax base, the move to the CCCTB would constitute a fundamental change and a major step towards a much more coordinated system of corporate income taxation in Europe. There is a number of reasons for a closer coordination of corporate tax policies in the European Union:

- Companies operating in the EU currently have to deal with 27 different national tax systems. This gives rise to high compliance costs.
- Many elements of the existing corporate tax systems create obstacles for border crossing economic activities in the European Union. These obstacles prevent the European Internal Market from developing its full potential for promoting economic growth and employment.
- Differences in effective tax burdens across member states distort economic activity in Europe.
- The growing importance of multinational companies makes it increasingly difficult to run a corporate tax system based on separate accounting. This system creates incentives for income shifting through transfer pricing and financing structures and gives rise to conflicts not only between taxpayers and tax authorities but also between tax authorities of different member states.
- Conflicts also arise between national tax policies and EC law. In a number of cases, EC Court of Justice Rulings have declared national tax rules incompatible with EC law, in particular with the freedom of establishment granted by the EC treaty.

[1] European Commission (2001).

The CCCTB is expected to solve some of these problems. But at the same time, the project raises a number of difficult issues. Next to the many technical challenges faced by every fundamental reform of the tax system, there are concerns regarding the economic implications of the common tax base: How would the introduction of the CCCTB affect corporate tax revenues of the member states? Would corporate tax competition become more or less intense under the new system? How would the CCCTB affect the position of the EU in global tax competition and its ability to react to external tax policy challenges?

In 2004, the European Commission created a working group which has the task to study and discuss options for introducing a CCCTB in the EU. Although the working group has not yet completed its work, the process is quite advanced and key elements of what is likely to be the final output are formulated in a number of working papers. The European Commission intends to present its proposal for the introduction of the CCCTB, which will be based on the results submitted by the working group, before the end of 2008. It is the purpose of this paper to review the current state of the Commission´s CCCTB project and to discuss some important issues and questions raised by the proposal. The setup of the paper is as follows. Section 2 summarizes what are likely to be the main elements of the proposal. Section 3 focuses on the mechanism for the sharing of the tax base. Section 4 evaluates the CCCTB concept in the light of economic criteria such as efficiency, fairness and simplicity. Section 5 discusses a number of specific issues and open questions. Section 6 concludes.

2. The main elements of the CCCTB Proposal

As mentioned above, the CCCTB proposal of the Commission is not yet finalized but a number of working papers generated by the working group exist where elements of what is likely to become the final proposal are described and discussed.[2] The current state of the debate suggests that the main features of the proposal will be as follows:

1. The CCCTB stipulates a common set of rules for the calculation of taxable profits of companies operating in EU member states participating in the CCCTB. The common tax base will be consolidated, which means that companies or corporate groups will be taxed on the basis of their overall income in all countries, rather than

[2] See European Commission (2007a-c, 2008 a,b). These papers are available on the webpage of the working group.

being taxed by each country separately. Among other things, this includes border crossing loss offset.

2. The CCCTB is optional. This implies that companies will have the option to be taxed under the CCCTB rules or to remain in the national systems.

3. For each company taxed under the CCCTB regime, the tax base will be apportioned to the member states according to a sharing mechanism. The working group considers a sharing mechanism based on the distribution of the companies` payroll, employees, assets and sales across countries. The formula will be the same for all member states participating in the CCCTB.

4. A key question is whether all EU member states will participate in the CCCTB. The working group recommends introducing the CCCTB in the framework of enhanced cooperation, which means that a subgroup of EU member countries would start and other countries may join in later.

5. In legal terms, the CCCTB will be implemented in the form of a directive under Art. 94 ECT, which means that unanimity in the Council will be required. Since it will not be possible to lay down every detail of the CCCTB and its administration in the directive, the directive itself would provide for the possibility of implementing measures under the so-called Comitology Procedure.

6. Member states will retain autonomy in setting the tax rates. How this can be combined with a common consolidated tax base will be explained in greater detail below.

3. Consolidation and the sharing mechanism

In order to understand how the CCCTB is meant to work, it is helpful to start by considering the way in which firms calculate their tax base and the way in which the sharing mechanism allocates this tax base to the member states. Under the current tax system, firms or, typically, groups of firms operating in more than one member state are usually obliged to submit separate tax declarations in each member state. Each declaration basically reports the profit generated within the member state. These profits are calculated using the respective national rules for the determination of taxable profits. If a multinational group makes a profit in one country but suffers losses in another country, it will usually be unable to set the losses against

the profits.[3] The introduction of the CCCTB would change this as follows. Firstly, a multinational group would calculate the EU wide income for each company of the group, using a common set of rules for the determination of taxable profits. Secondly, it would consolidate, which basically means that it would add up EU wide profits and losses.[4] As a result, each group would submit one tax declaration which reports its EU wide taxable income.

After the tax base of a group has been determined, it has to be apportioned to the member states, so that they can apply their tax rates to their individual shares of that tax base.[5] The main idea underlying the sharing mechanism for the tax base is that companies should pay taxes in proportion to their economic presence in a country. Economic presence is measured by the presence of employees, assets and sales. How exactly these factors should be measured and weighted is, of course, a matter where views may differ.[6] Moreover, a given formula may be more appropriate for some sectors than for others. Although it is desirable to avoid having too many different sharing rules, some sectors like e.g. financial services or transportation do require special treatment. The CCCTB working group has dealt with this issue, as will be explained further below.

As far as the standard mechanism for the sharing of the common tax base is concerned, the CCCTB Working Group makes the following suggestion. Consider a company called A, which belongs to a group of companies taxed under the CCCTB. The consolidated tax base of the group[7] is apportioned to each of its entities (i.e. companies or permanent establishments). Note that this is not the same as apportioning the tax base of the group to the member states directly. The reason for apportioning the tax base to the entities is that individual entities need to be able to calculate their individual tax liabilities. The apportionment is carried out according to the following formula[8]

[3] At least, this is what most national tax systems stipulate. EU law requires that national tax systems must not discriminate between national and border crossing loss offset regimes. Depending on the national regimes, this may force countries to create some room for border crossing loss offset

[4] In fact, consolidation for tax purposes is much more complex, see e.g. Scientific Advisory Board of the German Federal Ministry of Finance (2007).

[5] In principle, it would be possible to allow member states to also provide tax credits for certain companies or certain types of investment. But this is not part of the concept developed by the CCCTB working group.

[6] In this paper, we do not discuss measurement issues, mainly for reasons of space. For a discussion of these issues see European Commission (2007b), pp. 7-14.

[7] All taxable income, i.e. business income (income earned in the ordinary course of trade and business) and non-business income (passive income like e.g. interest, royalties and dividends), should be consolidated and apportioned on the basis of a given formula. Alternatively, one could think of using different allocation mechanisms for different types of income.

[8] See European Commission (2007b), p. 6.

$$TaxBaseA =$$

$$\left[\frac{1}{m}\frac{Sales^{A}}{Sales^{Group}}+\frac{1}{n}\left(\frac{1}{2}\frac{Payroll^{A}}{Payroll^{Group}}+\frac{1}{2}\frac{Number\ \ of\ \ Employees^{A}}{Number\ \ of\ \ Employees^{Group}}\right)+\frac{1}{o}\frac{Assets^{A}}{Assets^{Group}}\right]*CCCTB$$

with

$$\frac{1}{m}+\frac{1}{n}+\frac{1}{o}=1.$$

The superscript A refers to the sales (destination based), payroll, number of employees and assets of company A. This formula yields a share of the group´s tax base allocated to company A. How does this translate into the allocation to the member states? This question is not trivial because company A may, for instance, sell its output in several member states. However, as will be explained further below, the sharing mechanism is designed so that the allocation of the tax base to the entities of the group effectively also provides an allocation to the member states.

A key issue that arises with respect to the apportionment method is whether companies will pay taxes in countries where they have no physical presence. Here, ‘physical presence’ is used as a technical term. A company has a physical presence in a country if it has its legal residence or a permanent establishment in that country. For instance, a company may reside and produce in country A and sell part of its products in country B without ‘physical presence’ in B, which means that it has no subsidiary or no permanent establishment in B. Under the current tax rules, this company would not be subject to corporate income taxation tax in B. Under the CCCTB, the question arises whether this company would have to pay taxes in B because the apportionment formula includes sales as a factor.

The concept of the CCCTB working group implies that companies will be subject to tax in countries if and only if they have a physical presence in the country. The working group suggests two mechanisms to deal with cases where a company has sales in a country without having a physical presence in the same country. Firstly, if another entity of the group has a physical presence in that country, the sales will be apportioned to that entity. Secondly, in cases where the group is not physically present, a ‘spread throw back rule’ will be used, which means that the sales would be taken into account by the entities of the group residing in

all member states, proportionally to the other factors (assets and payroll/employees), implicitly giving more weight to these factors.

It is helpful to consider a simple example for the application of the sharing mechanism (see tables 1 and 2). Consider a group which consists of company A residing in the UK and company B residing in France. Company A produces and sells all its output in the UK whereas company B produces in France but sells its output in France and in the UK (see table 1). For purposes of tax base allocation, the UK sales of company B will be allocated to company A because the latter has a physical presence in the UK whereas the former does not. As a result, 44,4 per cent of the common tax base (i.e. the consolidated taxable profits of the group) will be allocated to the UK in our example and 55,5 per cent will be allocated to France.

Table 1: Example for Application of the Sharing Mechanism

Country		UK	France	Sum
	Payroll+Empl.	50		50
Company A	Assets	50		50
	Sales	100		100
	Payroll+Empl.		100	100
Company B	Assets		100	100
	Sales	100	100	200
	Payroll+Empl.	50	100	150
Group	Assets	50	100	150
	Sales	200	100	300
Tax Base Share		44,4	55,5	100

What happens if an entity of the group sells part of its output in a third country where none of the companies which belong to the group have a physical presence? Assume that company A reduces its UK sales by 50 and instead sells this output in Germany (see table 2).

Table 2: Example for Application of the Sharing Mechanism with Spread Throw Back Rule

Country		UK	France	Germany	Sum
	Payroll+Empl.	50			50
Company A	Assets	50			50
	Sales	50		50	100
	Payroll+Empl.		100		100
Company B	Assets		100		100
	Sales	100	100		200
	Payroll+Empl.	50	100	0	150

Group	Assets	50	100	0	150
	Sales	150	100	50	300
Tax Base Share		40,7	59,3	0	100

In this case, the spread throw back rule implies that the sales in Germany are allocated to the group´s companies in all other member states, in accordance with the weight of the other two apportionment factors (payroll+empl. and assets). This implies that the share of the tax base allocated to the UK drops to 40,7 per cent and the share allocated to France increases to 59,3 per cent.

As mentioned above, there are some sectors where the general formula described above may not be appropriate. The working group mentions financial services, transportation and television and broadcasting services and recommends that adapted variants of the general sharing mechanism rather than completely different formulae should be used for these sectors. In addition, a general escape clause is foreseen for cases where applying the general formula obviously leads to unfair or inappropriate results.[9]

4. Economic assessment of the proposal

How should the CCCTB project be evaluated from an economic point of view? From the perspective of the theory of optimal taxation, a tax system should minimize the costs of economic distortions, given the revenue it is expected to raise. In the case of the CCCTB, the key economic distortions to be addressed are distortions of the international allocation of capital, distortions between purely domestic and border crossing economic activity as well as distortions between firms or sectors within countries. Beyond this, the CCCTB may also change the way in which the tax system distorts the choice of financing structures like e.g. the combination of debt and equity, as well as the choice of the legal and the organisational structure of a firm.

In addition to the costs of economic distortions, taxation gives rise to administration costs for the government as well as compliance costs for taxpayers. The latter include the cost of accounting for tax purposes and the cost of professional tax advice. For instance, if a tax system is highly complex or if it offers many incentives for tax planning, this will involve

[9] See European Commission (2007b), p.17.

significant costs for both taxpayers and tax authorities. The impact of the CCCTB on these costs is an important aspect for evaluating it.

Next to these efficiency aspects, the CCCTB also has far reaching distributional implications. It will inevitably lead to a redistribution of tax revenue between member states, and it will also change the distribution of the tax burden faced by different taxpayers. These distributional effects may be evaluated in the light of fairness principles. For instance, the distribution of the tax burden among individuals is often evaluated in the light of the ability to pay principle. For the distribution of tax revenue among EU member states, fairness principles are also relevant. Frequently, though, the effects on the distribution of tax revenue are also debated from a political perspective, which emphasizes the prospects to reach a consensus for a reform. From this perspective, an important criterion is to what extent the introduction of a CCCTB would change the revenue distribution compared to the status quo. Large shifts in the distribution of tax revenue would probably make it more difficult to reach a consensus, as would large changes (in particular a decline) in the overall amount of revenue raised.

Last but not least, it is important to note that the CCCTB will affect tax competition within the EU and between the EU and third countries. It is not controversial that the CCCTB should avoid putting the EU at a disadvantage in global tax competition. As far as tax competition within the EU is concerned, the key question is whether or not the CCCTB will intensify competitive pressures, in particular the pressure to cut corporate tax rates. Unfortunately, despite the fact that the phenomenon of tax competition has received a lot of attention in research on international taxation, no consensus has emerged about whether or not an intensification of corporate tax competition within the EU would be a good or a bad thing.[10] An important insight that does emerge from the debate on this issue is that different countries may be affected very differently by tax competition. For instance, there are several small EU member countries with low corporate tax rates which are widely thought to benefit from tax competition under the current system whereas larger member states with higher taxes are often regarded as being negatively affected.

Moreover, efforts have been made to distinguish between different types of tax competition, of which some are classified as acceptable or even beneficial whereas others are classified as

[10] See e.g. Wilson and Wildasin (2004) or Fuest et al (2005).

harmful. For instance, tax rules and arrangements which allow foreign firms to shield part of their income from taxation in their country of residence have been criticized as reflecting a harmful type of tax competition. The distinction between 'harmful' and 'non-harmful' tax competition is controversial, though, for reasons which will be discussed further below.

To summarize, these considerations and criteria imply that the CCCTB should ideally

- contribute to overcoming the existing obstacles for border crossing economic activity in the EU
- reduce compliance costs faced by taxpayers and costs of administration borne by the tax authorities the tax system
- reduce economic distortions caused by the corporate tax system in general
- reduce tax planning and income shifting
- lead to a fair distribution of the tax burden among taxpayers and a fair distribution of revenue among the member states
- avoid a decline in the overall amount of corporate income tax revenue raised,
- improve the position of the EU in global tax competition and crowd back 'harmful' tax competition within the EU.

We will discuss each of these points below.

4.1. Overcoming tax obstacles to border crossing investment

It is probably the most important advantage of the CCCTB that, once companies do operate under the CCCTB regime, a number of existing tax obstacles to border crossing investment will disappear. These include limitations on border crossing loss offset, issues of exit taxation which arise when a company moves assets from one member state to another, transfer pricing disputes, conflicts about the tax treatment of border crossing interest payments and so on.

However, a key question is whether there will be tax obstacles to switching from the national systems to the CCCTB. Many of the tax issues which arise in the context of border crossing investment under the existing system of separate accounting also arise at the borderline between the CCCTB and the national systems. Most current tax obstacles to border crossing investment exist because there is a conflict between two legitimate interests: The interest of the national governments to protect their tax revenue, on the one hand, and, on the other hand, the 'European' interest in removing tax obstacles to border crossing economic activity.

The introduction of the CCCTB as such cannot overcome this conflict. It may, however, offer new ways of dealing with it. For instance, under the current system, member states are reluctant to let companies move assets abroad and defer taxation of the accumulated capital gains because they expect that enforcing the domestic tax will be much more difficult once an asset has moved to another jurisdiction. One aspect of CCCTB which might facilitate border crossing tax administration and enforcement is that cooperation between tax authorities will have to be intensified and become an integral part of day to day business for taxpayers and tax authorities. Given this, the option of taxing accumulated capital gains when they are realized, after exit, might be considered less unattractive than today. Thus, it may in fact be easier to remove tax obstacles between the national systems and the CCCTB than removing the obstacles under the existing tax system, where cooperation among tax authorities is less intensive.

4.2. Reducing compliance costs for taxpayers

Companies operating under the CCCTB regime will also have the advantage of not having to deal with the different national tax systems. This is likely to reduce compliance costs. The magnitude of the cost savings is difficult to estimate, though. It is also possible that the coexistence of the national tax systems and the CCCTB will increase compliance costs. At least, one has to expect that companies will invest in tax advice on the choice whether or not to opt for the CCCTB. Moreover, one may ask whether those companies who face the greatest difficulties dealing with the different tax systems – mostly the medium sized firms - will be those for whom the CCCTB is a viable alternative. Given that the reduction of compliance costs is widely seen as the most important argument in favour of introducing the CCCTB (see e.g. Mintz (2004)), the available evidence for this claim is not overwhelming, to say the least.

4.3. Consequences for the tax administration

From the perspective of the tax authorities, the CCCTB would bring about some improvements but it would give rise to a number of new challenges. On the one hand, the tax authorities would benefit from the fact that some sources of conflicts with taxpayers and tax authorities of other member states like e.g. transfer pricing disputes will lose importance. On the other hand, several other aspects of the CCCTB will place an additional burden on the tax

administration. Perhaps most importantly, all national tax authorities will have to administer two tax systems – the national tax systems and the CCCTB - instead of one. Moreover, there will be new forms of disputes between tax payers and the tax administration as well as disputes between the national tax authorities. The most obvious source of disputes is the application of the sharing mechanism for the tax base. Moreover, much more cooperation and exchange of information between tax authorities will be needed. Establishing this cooperation will require significant resources. But once these new structures are in place, the administration of the national tax systems may also benefit from them. Overall, though, there is no convincing evidence up to now which would demonstrate that the CCCTB will reduce administration costs.

4.4. Tax distortions of economic activity in the EU

The European Commission´s Report on Company Taxation (European Commission (2001)) puts a lot of emphasis on the distortions of economic activity in the European Internal Market, in particular distortions of the capital allocation (violations of capital export neutrality)[11], caused by differences in effective corporate income tax rates between member countries. The introduction of the CCCTB will remove distortions caused by differences in the tax bases. It will also remove distortions caused by specific tax obstacles to border crossing investment, which include limitations to border crossing loss offset, exit taxation and so on. But the most significant factor driving differences in effective tax burdens across countries, the statutory tax rates, will not be harmonized. This implies that tax distortions of the capital allocation will continue to exist.

In addition, new distortions will arise. Firstly, new distortions will arise due to the fact that some firms will operate under the CCCTB while others will remain under the national tax systems. The effective tax burden under these two regimes will differ. Secondly, differences in tax rates will give rise to distortions in the use of all factors of production entering the formula.[12] For instance, since payroll enters the formula, tax rate differences will give rise to distortions in employment between member states. Since the suggested formula includes three factors, the hope is that the tax distortions of each individual of these factors will be smaller

[11] There are several other relevant distortions like e.g. violations of capital import neutrality or ownership neutrality. Assessing the impact of the CCCTB on these dimensions of tax distortions would be beyond the scope of this paper, though.

[12] See McLure (1980) and Gordon and Wilson (1986). Empirical evidence for this type of distortion is provided by Goolsbee and Maydew (2000) and Riedel (2008).

than the distortions under the existing system. Whether this is appropriate is an open question, though. Thirdly, under formula apportionment, the tax burden faced by a firm depends much more on the group to which it belongs than under separate accounting. Therefore distortions of ownership patterns are likely to increase.[13] Fourthly, one might also argue that the existing system of separate accounting offers so many opportunities for tax planning and income shifting from high to low tax jurisdictions that effective tax rate calculations which abstract from tax planning overestimate the tax distortions under the existing system. To the extent that the CCCTB makes profit shifting more difficult, distortions of real economic activity might even increase.[14]

For these reasons, at least in the short and medium term, generally reducing tax distortions of economic activity in the European Internal Market is probably not the best argument in favour of the CCCTB. This is certainly an important weakness of the project.

4.5. Tax Planning and Income Shifting

Tax planning and international income shifting is a source of growing concern for national tax authorities in EU member countries, in particular in high tax countries. There is a growing body of empirical work, surveyed in Devereux (2007), which suggests that tax differentials do exert a significant impact on the location of book profits.

One reason to introduce the CCCTB is that the current tax system, which is based on separate accounting, is vulnerable to profit shifting through transfer pricing, debt financing and other tax planning instruments. Under the CCCTB, many forms of profit shifting will disappear. Of course, this only refers to profit shifting among countries participating in the CCCTB. Profit shifting to third countries is another issue, which will be discussed further below. The fact that the CCCTB will put an end to certain forms of profit shifting raises two questions. The first is whether the CCCTB also creates new profit shifting possibilities.[15] The second is whether it is really desirable to reduce profit shifting.

[13] In a recent paper, Hines (2008) develops a method to measure the magnitude of ownership distortions caused by different formulae. He argues that ownership distortions arise to the extent that the distribution of income across firms under separate accounting differs from the distribution of factors entering the formula.

[14] Van der Horst et al. (2007) use a computable general equilibrium model to analyse the welfare effects of introducing CCCTB. They find that these welfare effects are negligible, mainly because distortions of real economic activity increase.

[15] Of course, profit shifting to third countries remains a problem and may even be intensified. For a theoretical discussion of this issue see Riedel and Runkel (2007) and Becker and Fuest (2007).

The answer to the first question is yes. The CCCTB does create new profit shifting incentives and opportunities. Firstly, profit shifting may occur at the borderline between the national tax systems and the CCCTB. Secondly, the CCCTB offers significant profit shifting and tax planning opportunities. Some of these are related to thresholds which define whether or not a company belongs to a group and whether or not a firm has a physical presence in a member state. For instance, a group which has large sales but no physical presence in a member state with low tax rates may significantly reduce its overall tax burden by setting up a small permanent establishment in that member state. Likewise, a company which resides in a high tax country and exports to low tax countries may reduce its tax burden by becoming part of a group of companies residing in low tax countries, due to the spread throw back rule for the allocation of sales. These are just very simple examples.

The answer to the second question raised above, the question of whether profit shifting is beneficial or harmful is, perhaps surprisingly, more ambiguous. On the one hand, profit shifting is clearly harmful because tax planning and (legal) tax avoidance are costly activities. Taxpayers invest resources in tax planning because there are benefits to this type of investment in the form of tax savings. But for the economy as a whole, taxes are only transfers from the taxpayer to the government, so that any investment in tax avoidance is socially wasteful. This suggests that profit shifting is a harmful activity and closing tax loopholes and tax havens would be desirable (see e.g. Slemrod and Wilson (2007)).

On the other hand, profit shifting may also have positive economic consequences. Tolerating international tax planning and profit shifting may be considered as a way of reducing the tax burden on highly mobile international firms relative to less mobile, national firms (see also Hong and Smart (2006)). If this option for 'price differentiation' is no longer available, countries may be induced to reduce the tax burden on less mobile bases as well, which means that the cost of tax competition in terms of revenue losses and, finally, an underprovision of public goods, becomes larger, as Keen (2001) points out.

4.6. A fair distribution of the tax burden among taxpayers and a fair distribution of tax revenue among member states

How should we assess the contribution of the CCCTB to a fair distribution of the tax burden among taxpayers? This depends on the fairness criteria used in this regard. Two types of fairness criteria immediately come to mind. The first is the 'ability to pay principle'. In a nutshell, it implies that taxpayers A and B should face the same tax burden if their ability to pay is equal (horizontal equity). If taxpayer A´s ability to pay exceeds that of taxpayer B, A should pay more taxes than B, and vice versa (vertical equity). Income is usually considered to be the best indicator for ability to pay. Even in the realm of personal income taxation, this principle raises at least as many questions as it answers. With regard to companies, it is even more difficult to apply because the burden of taxes can ultimately only be borne by people, not by companies as such.[16] But this is an issue faced by every corporate income tax system, not just by the CCCTB.

Despite this difficulty, it is possible that the CCCTB does contribute to taxation which is more in line with the ability to pay principle. One reason is that limitations on border crossing loss offset or limitations on the deductibility of interest in the existing, national tax systems, do imply that the ability to pay principle is violated in the sense that a multinational company may pay taxes even if its EU wide consolidated profits were equal to zero whereas a national company would not.[17] Another reason is that, if the CCCTB closes tax loopholes for multinational firms and reduces profit shifting opportunities, it will avoid that multinational firms, who have access to profit shifting, pay lower taxes compared to national firms.

Another approach to fairness would put more emphasis on the principle of fiscal equivalence, which implies that firms should pay taxes to the extent that they use the public infrastructure and benefit from public services in a country. As a guideline for the distribution of the tax burden between firms, this principle faces the difficulty that taxes exist mainly because it is the nature of public services that the benefits cannot easily be attributed to individual taxpayers. If they could, these services could be financed through fees and congestion charges or, if exclusion is possible, even provided by the private sector.[18] Another issue that arises in this context is whether profit is an appropriate base for taxation according to the principle of

[16] The CCCTB working group offers an interesting interpretation of the ability to pay principle: "The 'ability to pay' could be relevant when considering whether or not unrealized profits should be taxable"(European Commission (2004), p. 3). This points to the important relationship between taxation and liquidity, an issue which is neglected in standard tax theory but highly important in tax practice.

[17] Even if one takes into account that ability to pay should refer to individuals like e.g. the ultimate owners of a firm, it is unlikely that fairness defined as taxation according to ability to pay will call for taxing firms which do not make profits.

[18] On this issue, see also Sinn (1997).

fiscal equivalence. Whether or not companies benefit from public services is probably independent of their profitability. Despite these objections, the view is widespread that a company operating in a country should also contribute through corporate income taxes to the financing of public services in this country because it is also likely to benefit from these services. From the perspective of fairness in the distribution of tax revenues among member states, the principle of source country entitlement may be interpreted as leading to similar conclusions.

The contribution of the CCCTB to implementing taxation according to the principle of fiscal equivalence or source country entitlement is ambiguous. On the one hand, the fact that the sharing mechanism distributes the tax revenue according to economic presence is in line with the idea that countries are likely to benefit from public services provided by a country in proportion to its economic presence.[19] On the other hand, consolidation implies that a company with very profitable activities in one country may pay no taxes in this country because losses of the group to which the company belongs in some other country reduce the consolidated profits of the group to zero. At this point, a conflict emerges between the principle of taxation according to the principle of fiscal equivalence and the principle of ability to pay.

Another variant of the principle of source country entitlement is the so-called "equal earned income" approach (Agundez-Garcia, 2006). According to this approach, equity or fairness in the distribution of tax bases between countries would require that "jurisdictions in which the resident business units are equally profitable (in absolute terms) should get equal shares of the CBT (the common tax base, C.F.)", ibid., p.33. This concept is based on the assumption that the profits of a multinational firm can be traced to geographical sources in a meaningful way. Of course, whether this is the case is highly controversial. One of the reasons for replacing separate accounting is precisely that it is often difficult to determine the geographical source of profits. The available evidence, however (see e.g. Fuest et al (2007) or Hines (2008)) suggests that the distribution of earnings (as measured under the separate accounting system) differs significantly from the distribution of apportionment factors, in particular from the distribution of payroll.

[19] One should note, though, that economic presence in a country does not necessarily imply that the income of a firm is also generated in this country. For instance, the fact that a firm has a large number of employees in a country does not mean that a corresponding share of the firm´s income is generated in that country.

4.7. How will the CCCTB affect tax revenue?

The European Union´s experience with other initiatives in the area of taxation suggests that the prospects for a success of the CCCTB project critically depend on its impact on tax revenue. The tax revenue implications of introducing CCCTB are difficult to predict, not only because of limited data availability but also because such a reform is likely to induce significant behavioural adjustments which are hard to predict. Of course, the revenue effects will also depend on the number of participating countries, the formula which is implemented, the question of whether or not firms will be allowed to opt for or against being taxed under the CCCTB rules and many other aspects of the system.

Existing studies of the revenue effects point out that introducing CCCTB would affect both the overall size of the corporate tax base and its distribution across the member states. Fuest et.al. (2007) investigate this using data from German multinational firms. They find that, due to border crossing loss offset, the corporate tax base falls by approximately 20 per cent. Moreover, the distribution of the tax base across countries changes. As one would expect, countries with low corporate tax rates or special regimes, which are considered to benefit from the shifting of book profits under the existing tax system, lose tax base. This reflects that the distribution of the tax base is more in line with the distribution of economic activity as reflected by employment and assets. Another reason is that there is no reason to assume that the distribution of corporate income is the same as the distribution of the apportionment factors, in particular labour.[20] One important limitation of this study, however, is that it only includes data from German multinational firms. Devereux and Loretz (2008) analyse the revenue effects of introducing formula apportionment for a dataset of European multinationals. They distinguish between the cases of voluntary and mandatory participation. The results suggests that overall tax revenue would drop by 2.5 per cent in the case of voluntary participation and that it would increase by 2 per cent in the case of mandatory participation.[21] Unfortunately, none of these studies takes into account the sales factor. A common finding is that there is a significant redistribution of tax revenue between member

[20] One should take into account that payroll is a deductible item, i.e. an increase in payroll c.p. reduces profits. The empirical results in Hines (2008) suggest that the distribution of payroll or the number of employees across firms is more or less unrelated to the distribution of income.

[21] The difference of this result to Fuest et al. (2007) may have a number of reasons which include the differences in the data used. Note however that a decline in the tax base may be compatible with even positive tax revenue effects because part of the tax base is shifted from low to high tax countries.

countries. This is likely to hold even if the sales factor and additional aspects like the treatment of unrealized capital gains are taken into account.

It is likely that member countries which lose tax revenue will ask for some compensation. If the tax base as a whole becomes smaller, this issue will even become more pressing. So far, the CCCTB working group has made no suggestions how to deal with this question. In theory, a clearing mechanism or some form of fiscal transfer mechanism could be implemented to compensate the losers. But given the high volatility of corporate income tax revenue, and taking into account the experience in the case of the value added tax, it is unlikely that a compensation mechanism can be found which would be accepted by all member states. From this perspective, it is certainly an advantage of the current CCCTB proposal that those member states which face larger revenue losses may decide not to participate. Of course, it remains to be seen whether a subgroup of member states exists where the revenue effects are so balanced that they do not create an insurmountable obstacle to the introduction of CCCTB.

4.8. Effects on tax competition

Given that the member states will retain autonomy in setting their corporate income tax rate, it cannot be expected that the introduction of CCCTB puts an end to tax competition in the EU. It is one of the stated objectives of the CCCTB working group, however, to submit a proposal which avoids that tax competition is intensified. Whether this can be achieved is an open question. From a theoretical point of view, a switch from separate accounting to formula apportionment may induce countries to increase or decrease their tax rates. As mentioned in the preceding sections, taxes will continue to matter for the location of production, and possibilities to shift book profits to low tax countries will continue to exist. There is currently no basis for predicting either an increase or a decline in the intensity of corporate tax competition. This is not only true for the comparison between the current system and formula apportionment but also for different variants of formula apportionment. For instance, giving a larger weight to (destination based) sales would reduce incentives for countries to cut taxes because in most cases, firms will find it easier to shift their production from one country to another than to shift the destination of their sales. On the other hand, some aspects of the sales factor, in particular the spread back rule, imply that the allocation of sales, rather than the sales themselves, may be rather mobile. For instance, firms with sales in low tax countries have strong incentives to set up a physical presence in that country whereas firms with sales

in high tax countries will avoid having a physical presence. Moreover, the CCCTB may induce countries to engage in tax competition through lax enforcement, as will be discussed further below.

An issue of particular importance is how the CCCTB will affect tax competition to third countries. There are concerns that decision making on the CCCTB might not be flexible enough to react quickly enough to changes in the economic environment. The individual member states will be able to react by adjusting their tax rates, but necessary tax base adjustments would require unanimity. It seems necessary to think about ways in which a more flexible tax policy reaction can be made possible.

5. More specific aspects of the CCCTB proposal

In this section, we discuss some more specific issues and open questions of the CCCTB concept. These include the scope of the CCCTB, the choice of the common rules for tax base calculation, the deductibility of social security contributions and local taxes, rules for the transition between the national systems and the CCCTB, the treatment of foreign source income, provisions against tax planning and profit shifting and the administration of the new tax system.

5.1. What is the scope of CCCTB?

Which companies should be eligible for the CCCTB? The working group suggests that all companies which are subject to member state corporate income tax would also be eligible for taxation under the CCCTB. This would include companies residing in the EU as well as companies residing in third countries. The latter would be eligible with their permanent establishments in the EU.

A controversial issue is the role of optionality. There are several alternatives to generally allowing companies to opt for or against the CCCTB. Firstly, the common tax base could be mandatory and consolidation could be made optional. Secondly, the decision on optionality could be left to the member states when implementing the CCCTB directive. It seems though, that there is little support for either of these alternatives. A common tax base without consolidation would imply that there would be no or only incomplete border crossing loss

offset, so that an important tax obstacle to capital mobility in the EU would continue to exist. Leaving the decision on optionality to the member states would invite strategic behaviour by the member states, who would have incentives to make this decision depending on the effect on national tax revenue or the effect on the tax burden faced by domestic firms. Moreover, it would increase the complexity of the new system.

5.2. Which accounting rules for the determination of the tax base?

The project of introducing common rules for the calculation of taxable profits requires agreement on which rules should be used. Existing examples of common tax bases and formula apportionment are usually corporate taxes levied by subcentral governments of federal states like e.g. Canada, the US or Germany.[22] In these cases, the federal tax base is a natural starting point for the definition of the common tax base. For the EU, no such obvious starting point exists. Existing tax bases of member states could only serve as a starting point if there was agreement about which member state´s tax base would play this role.

For some time, the debate focused on the idea to use IAS/IFRS as a reference to develop tax accounting rules for the common base. Several objections have been raised against this approach. Firstly, IAS/IFRS are set by a private organization, the International Accounting Standards Committee (IASC) based in London. But tax legislation cannot be made outside the public domain. This objection to using IAS/IFRS is not very convincing. It is clear that IAS/IFRS need to be formally 'endorsed' by the European Commission before they become binding under EC law.[23] Neither the existing standards nor revisions made by the IASC would automatically have an effect on tax law. A second objection points to the fact that IAS/IFRS are designed to convey information to financial market investors or creditors about the earnings prospects of companies, not for the purpose of taxation. This implies that they tend to use all available information on factors which might affect future profits of companies, giving equal weight to positive and negative factors. Tax accounting rules, in contrast, usually put emphasis on realized earnings and rely on a more 'conservative' or 'prudent' approach to accounting. Again, IAS/IFRS rules may, in principle, be adjusted to take this into account. A third objection is that not all member states allow companies to use

[22] In Germany, the local business tax base of firms operating in more than one jurisdiction is shared using an apportionment formula based on payroll.
[23] See e.g. Schön (2004), p. 428. This also avoids that the financial accounting standards faces pressures by national governments or business motivated by tax consequences of standard setting.

IAS/IFRS for individual company accounts.[24] It is therefore difficult to avoid that many companies will start from accounts prepared in accordance with national GAAP (generally accepted accounting principles) and make adjustments specified by the CCCTB rules to compute their taxable profits.[25]

All this implies that IAS/IFRS are useful as a reference or a starting point to develop the common tax base, but ultimately the CCCTB will have to be based on a set of autonomous tax accounting rules. Accordingly, the CCCTB Working Group does report that, during its work, constant reference has indeed been made to IAS/IFRS,[26] but it also emphasizes the fact that there will be no direct formal link between IAS/IFRS and the CCCTB.

5.3. The definition of taxable income and the deductibility of social insurance contributions and local taxes

Since the rules for the determination of taxable income differ widely across member states, it is not surprising that there are many complex and controversial issues when it comes to the definition of taxable income. These include the definition of income and expenses for tax purposes, the treatment of dividends and capital gains on participations and so on. From a tax policy perspective, a particularly important issue is the deductibility of social security contributions and local taxes. In the existing national tax systems, social insurance contributions are usually part of the wage cost and can be deducted from the corporate income tax base. This also applies to many local taxes.

Under the CCCTB, this deductibility is controversial. Deductibility would imply that changes in tax rates or social security rates of one member state would have a direct impact on the revenue accruing to other member states. Moreover and more importantly, the way in which social insurance systems are financed differs widely across member states. Some member states mainly use general tax revenue to finance social security expenditures whereas others use social security contributions, which are usually levied in proportion to wage income, at least up to some contribution ceiling. This raises the question of whether deductibility of social security contributions would put member states with tax financing of social insurance

[24] For a more detailed discussion of this issue see Freedman and MacDonald (2008).
[25] This is not without problems because it is not clear how it can be avoided that the differences between the national GAAPs translate into differences in the effective taxation of companies in different member states.
[26] See European Commission (2008a), p. 5.

expenditure at a disadvantage.[27] Clearly, the CCCTB project cannot be made conditional on a harmonisation of the financing of social security. The working group therefore argues that, in principle, social security contributions should be deductible, and the consequences for the common tax base and, ultimately, for the distribution of tax revenue, simply have to be accepted. This is not a very satisfactory conclusion because the incentive for member states to free ride on the common tax base should be taken seriously.

A similar issue is raised by local taxes paid by firms, which are sometimes deductible from national corporate income tax bases. The question is whether they should also be deductible from the CCCTB. The function of local taxes differs widely among countries. In some member states, they serve as fees for the provision of specific services like e.g. waste collection. In others, there is no direct link between these taxes and specific services. In Germany, for instance, the local business tax (Gewerbesteuer) is a general source of revenue for local governments, and no direct relationship to specific public services exists.[28] One possibility to deal with this would be to make local taxes deductible from the individual national shares of the common tax base. But the working group objects to this quite convincingly that such an approach would complicate the CCCTB significantly.[29] How this problem will finally be resolved is an open question.

5.4. Issues of transition between the national tax systems and CCCTB

In many companies, the book values of assets differ significantly from their market value. If a company switches from the national tax system to the CCCTB or vice versa, the question arises how this difference will be dealt with. Essentially, this is a problem of exit taxation, which occurs under the existing tax systems e.g. when companies move assets across borders.

At this stage (European Commission (2008a)), the working group prefers a solution where companies would enter the CCCTB with their tax written down asset values, rather than with their fair market values. Of course, this raises the question of whether special arrangements are required to treat the underlying unrealized capital gains (or losses) built up in the member

[27] It should be taken into account that taxes levied to finance social insurance systems like e.g. income taxes may drive up wage levels, so that these taxes are also effectively deductible from the common tax base. But whether this is a full compensation remains an open question.
[28] Since 2008, the German local business tax is no longer deductible from the corporate income tax, so that the question of its deductibility under CCCTB may no longer be relevant.
[29] See European Commission (2008a), p.4.

state before entering the CCCTB sphere. One possibility would be to foresee no special treatment, so that these gains would be treated in accordance with the CCCTB rules and shared according to the sharing mechanism. But this would imply that the member state where the capital gains (or losses) have been built up would lose (or gain) significant amounts of tax revenue. The working group prefers another solution, a deferral rule implying that capital gains or losses would be recorded when the company enters the CCCTB, but their taxation would be deferred until the moment of their realization. An equivalent rule would apply if a company leaves the CCCTB.[30] This approach is familiar from the debate on exit taxation in the existing, national tax systems. Unfortunately, it raises difficult legal and administrative issues. Among other things, close cooperation among national tax authorities is required. Of course, this is something which is needed under the CCCTB anyway, as mentioned above.

5.5. The treatment of foreign source income

How will foreign source income be treated under the CCCTB rules? Currently, the EU member countries apply different methods for taxing foreign income. In principle, if a common tax base was introduced without consolidation, each country could continue to tax foreign income of firms taxed under the new rules as it does now. But consolidation implies that a common regime for taxing foreign profits is required.

The suggestions made by the CCCTB Working Group are as follows.[31] In principle, companies operating under the CCCTB regime are subject to corporate tax on their worldwide income. But this is subject to double taxation relief. Double taxation relief is suggested to work as follows: Dividends received from major shareholdings and from permanent establishments in third (non-EU) countries are exempt. Portfolio dividends and other passive income (interest income) would be taxed with a credit for foreign withholding taxes paid. The working group also raises the possibility that exemption may be extended to portfolio investment as well to relieve economic double taxation.

To the extent that foreign source income will be taxed under the CCCTB, the question arises how the tax base is shared between the member states and how the maximum tax credit will be determined. In general, taxable foreign source income would be shared among the member

[30] European Commission (2008a), p.3.
[31] European Commission (2007a), p.29-34.

states according to the apportionment formula. For instance, consider a group which receives a passive income dividend of e.g. 100 Euros before foreign taxes from a third country subsidiary. The group has equal amounts of assets, sales and employees in two member states. In this case, 50 Euros of foreign source income would be allocated to each member state. Each member state would tax this income and provide a credit for foreign taxes paid. A general mechanism for determining the maximum tax credit in more complex cases still has to be found.

5.6. Provisions against tax planning and profit shifting

Another question that arises in the context of tax regimes for foreign profits is whether measures have to be taken to protect the common tax base against profit shifting to low tax countries. The working group considers various possibilities: Firstly, a switch over to the tax credit method[32] in cases where the corporate tax rate in the source country is very low[33] and, secondly, controlled foreign corporation (CFC) rules. CFC rules have the following purpose: Even if a country taxes domestic companies on their worldwide income, taxes on the earnings of foreign subsidiaries will normally be deferred until these earnings are repatriated. This creates incentives to set up subsidiaries in low tax countries and accumulate and reinvest earnings there. CFC rules would imply that, under certain circumstances, the earnings of these subsidiaries would be taxed upon accrual, i.e. the deferral until repatriation would be suspended. How exactly the CFC rules of the CCCTB will be designed and how they will be related to the switch over rule is an open question.[34]

A related issue is whether measures have to be taken to restrict the deductibility of interest on debt in order to avoid tax planning based on the allocation of debt and equity. Traditionally, thin capitalization rules, i.e. rules which put a ceiling on the amount of interest on debt a company may deduct from the tax base, only applied to interest payments to related parties like e.g. a foreign subsidiary or parent. But recently, several EU member states have introduced rules generally limiting the deductibility of interest to a certain threshold of overall

[32] Here, the term 'switch over' refers to situations where the tax law would normally exempt repatriated foreign profits from domestic taxation, but special circumstances like e.g. a very low foreign tax rate allow the domestic tax authorities to switch to the tax credit method and tax the dividend.
[33] As a threshold for this switch over, a foreign corporate tax rate of 10 per cent or of 40% of the average tax rate in the EU is discussed.
[34] It should be noted that CFC rules also apply to retained earnings of foreign subsidiaries whereas switch-over rules only apply when earnings are repatriated, so that switch over rules cannot really replace CFC rules, see European Commission (2008b), p. 6.

earnings before interest and taxes (EBIT) or earnings before interest taxes, depreciation and amortization (EBITDA). The working group has not taken any decisions yet as to which type of thin capitalization rule should be adopted. As a minimum, though, it proposes a rule which limits interest payments to related parties on the basis of a fixed debt/equity ratio.

5.7. Tax administration

Since there is no European tax administration, the administration of the CCCTB will be in the hand of the national tax authorities. Given that the firms opting for the CCCTB will typically be firms operating in more than one member state, the question arises which tax administration will be responsible and which entity of a corporate group will submit the consolidated tax return. The approach suggested by the working group[35] is referred to as the 'one stop shop' approach and may be summarized as follows: There will be a 'principal taxpayer' and a 'principal tax authority'. The principle taxpayer would be the ultimate parent company of the group, provided that it resides in a member state. If it does not, it will be the parent company of the EU subgroup. If there is more than one EU subgroup, the group may choose the parent company which will be the principal taxpayer. The 'principle tax authority' would be the tax authority of the country where the principle taxpayer resides.

The administration would be based on a system of self assessment. The return of a consolidated group would be submitted by the principle taxpayer to the principle tax authority. The return would be based on the records of each entity of the group, so that audits would also have to be carried out by the local tax authorities, not just the principal tax authority. The audit process should nevertheless be coordinated by the principle tax authority because the administrative process including the determination of the shares apportioned to the member states cannot be completed before all procedures in all member states are completed. The working group also suggests that there should be a single administrative appeal process and that judicial appeal should also be made in the member state where the principle taxpayer resides.

The fact that one tax authority would effectively responsible for taxing the EU wide activities of corporate groups raises a large number of practical and administrative issues, most of which may be addressed by closer cooperation among the tax administrations of the member

[35] See European Commission (2007c).

states. But there is also a fundamental incentive problem. The tax authorities of individual member countries, in particular smaller countries, only have very limited incentives to audit firms and to enforce taxes. In fact, quite the opposite may be true: Countries may want to attract corporate headquarters by offering a lax tax administration. Attracting corporate headquarters is attractive for a country, in particular because it involves the creation of jobs for highly qualified employees. The cost of a lax tax administration, the foregone tax revenue, would be shared among all member states.[36] The CCCTB working group is aware that common standards for auditing have to be defined, but how this will work in practice is an open question.

6. Conclusions

Overall, the emerging CCCTB proposal of the European Commission is a carefully prepared initiative and an important contribution to the European tax policy debate. But its aim is of course to convince at least eight member states to go ahead and introduce the CCCTB. Whether this will work is an open question. From the perspective of criteria such as efficiency and fairness of the tax system, the achievements of the CCCTB are rather modest. What is missing up to date is convincing evidence of direct economic benefits from introducing the CCCTB which are significant enough to convince the member state governments that the project is worth the effort. Whether the impact assessment which is currently under way will provide such evidence remains to be seen.

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