Europe slowly lurches to a Common Consolidated Corporate Tax Base: Issues at Stake

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The European Union is moving ahead, albeit slowly, towards a proposed system to harmonize corporate income tax bases for companies operating in EU member states. Beginning with several broad proposals (Commission on European Communities (2002)), discussions have become focused on the adoption of a common consolidated corporate tax base that would be similar to that used in Canada and the United States to integrate corporate tax bases.

In the discussion below, I shall review the various issues involved with establishing a common tax base in Europe with reflections and comment on whether some of the discussion is headed in the right or wrong direction, as an outside observer. In my view, a long road remains ahead but the progress has been more substantial than what I would have expected, given the lack unanimity among member states for a harmonized corporate tax base. The rationalization of business activity at the pan-European level and the challenges arising from European Court of Justice decisions, typically centred on the principles of freedom of establishment under the EU treaty, have forced European governments to seek new approaches to corporate tax policy. Thus, economic, compliance and administrative costs arising from separate taxes operating in each EU country is becoming a greater barrier to consolidation of the European corporate sector, ultimately leading to a need to integrate European corporate tax bases.

If any advice that needs to be given is that the EU should have a system that is relatively simple – it would not be useful to be too "pure" in the selection of factors, income and other aspect of the common base. Otherwise, administrative and compliance costs become too large in developing a common corporate tax base that would be apportioned to member states participating in the system.

What's it all about?

Prior to assessing current European proposals, it is useful to lay out some principles that serve as a guide towards a good corporate tax system in Europe.

By their nature, taxes are beneficial to fund public services but they inevitably result in economic, compliance and administrative costs. Each member state in a new system will be concerned about the effect that consolidation would have on its own revenue. Both governments and the taxpayers will be concerned about reducing the costs associated with the collection of taxes. With respect to costs, the best corporate tax structure is one that is efficient (minimizes economic distortions), fair (similar burdens on business activities), and does not result in undue administrative and compliance costs.

A move from separate member state corporate tax systems to a common consolidated corporate tax base results in a significant change to the calculation of corporate taxes. Instead of calculating corporate profits and taxes by each member state, harmonization would result in the aggregation of profits determined by a common tax base and apportioning amounts by a formula to determine profits earned in each jurisdiction. The apportioned profits would be taxed at a rate selected by the jurisdiction. In Canada, provincial governments typically use tax credits to vary the tax burden by business

activity. In the US, state governments make adjustments to the common base, choose apportionment factors or allow for tax credits to change tax burdens across countries.

Given the current separate European tax bases, what are the gains that could be achieved from consolidation of corporate tax bases? Any system of formulary apportionment is not perfect and, based on Canadian and US experience, a common consolidated corporate tax regime is bound to result in economic, compliance and administrative costs. However, one would like to see some improvement with a consolidated tax base compared to the existing state of affairs.

A consolidated tax base would improve both efficiency and fairness to the extent that differences in tax bases among member states are reduced, tax bases are better coordinated, companies are more able to set off losses from economic profits and a more coherent treatment of outbound and inbound investment from Europe is developed.

Administrative and compliance costs could also be reduced under a common consolidated tax base to the extent that transfer prices for transactions between related prices become less critical in determining tax liabilities, businesses have fewer rules to determine their European profits, and governments can reduce their reliance on legislative policy and administrative practices that try to combat tax avoidance and evasion.

Some evidence even suggests that the apportionment method for corporate income taxes reduces the scope for profit shifting. Mintz and Smart (2004) found that corporate profits were less sensitive to corporate rate changes for companies that allocated income to more than one province compared to multi-jurisdictional companies that did not allocate income but operated in more than one jurisdiction with separate subsidiaries (Canada does not permit consolidation for tax purposes). With a reduced incentive to shift profits, governments would also have less incentive to engage in tax competition to counter income-shifting by multinationals from high to low-tax jurisdictions.

Policy analysts often focus on the economic gains from moving to a common consolidated corporate tax base by reducing differential tax burdens on businesses. Yet, both Canadian and US experience shows that provincial and state governments have considerable leeway to adjust their tax rates, exclusions and credits so that tax burdens could vary significantly across business activities (Mintz (2004) for the Canadian analysis). The most important gain to taxpayers arising from formulary apportionment is to reduce compliance costs. The gain to governments is improving their ability to collect and administer taxes, especially reducing the scope for transfer price and financial manipulation to shift profits from one jurisdiction to another.

To sum up, three important reasons can be given for Europe to adopt a common consolidate corporate income tax base.

- European economic integration makes it increasingly difficult to administer corporate tax bases with separate accounting, especially with respect to transfer pricing.

- Companies wishing to operate at the pan-European level would be able to reduce compliance costs with the tax system, one of the barriers to economic integration.
- The use of an apportionment or allocation method for a common corporate income tax base could counter tax competition in terms of corporate rate cuts, compared to existing regimes.

Thus, it is critical that any proposal to move to a common consolidated tax base should improve efficiency, fairness and compliance/administrative cost reduction compared to existing tax systems.

What are the Issues?

In developing a common consolidated corporate tax base for Europe, a large number of issues need to be resolved. A recent paper (European Commission 2007) provides a review of the current issues left for agreement that provides a good basis for discussion below.

With EU discussions, corporate tax harmonization is focused on a common consolidated tax base using formulary apportionment. Other options, particularly home state taxation, have been dropped from the agenda, an outcome that I believe is probably best. The specific issues that need to be dealt with in developing the approach is listed in the attached table. I will review various components.

The Tax Unit and Base

As many have noted in the past (see McLure (2006) and Weiner (2006)), a difficult issue faced by European negotiators is determining the tax base for a common corporate tax. Unlike Canada and US where the federal corporate income tax is a good starting point for developing a common base, Europe has no central taxing authority. Thus, EU member states have been looking at International Accounting Standards as a starting point to determine the common base although there will not be a formal link between IAS measures of profits and taxable profits.

This is probably the best that one can do since using accounting standards has its limitations. Accounting is at times judgmental and options are sometimes available to companies to determine their profits. Practices can vary across companies and countries. With private companies that have less with concern over reported earnings, businesses can manipulate tax payments by choosing alternative inclusions and deductions. Thus, a fairly common set of rules should be developed and these would differ from accounting practices that vary across jurisdictions.

A similar issue arises in determining whether a member state has the right to tax a company. Canada and US use rules to establish whether the sub-national government may receive apportioned income but these rules are established by federal legislation. In the case of Europe, permanent establishment rules can vary across European countries so some harmonization will need to be considered.

Consolidation

In principle, consolidation of income of corporate group members should be implemented – otherwise companies can choose for tax reasons to organize themselves as single entities by state or as a consolidated company subject to apportionment rules. Such choices can increase the scope for tax planning such as transfer pricing and financial restructuring. The US requires consolidation that reduces the scope for tax planning. Canada, as mentioned above, does not permit consolidation so companies have an option to avoid the formulary approach. Many Canadian companies are subject the allocation system rather than setting up separate subsidiaries by province for both tax and non-tax reasons – about 55 percent of corporate taxable is allocated among provinces in Canada.[1]

The Canadian experience has shown that it can be hard to adopt consolidation if it is not in place. A 1985 federal proposal to adopt a UK-style loss transfer system among members of a corporate group failed as a result of provincial resistance, particularly those provinces that were bound to lose corporate revenues.

The EU discussions have focused on whether to adopt or not a consolidation system for those companies opting for apportionment of a common base rather than staying with their own tax bases. While adoption of a consolidation would be similar to the US, the option to adopt a common base puts the system closer to the Canadian model, which effectively allows companies to choose whether to consolidate activities or not across member state boundaries.

The EU option to adopt the common base would lead some revenue loss[2] from tax planning and will require more compliance and administrative resources when both separate accounting and consolidation are both in place. Without consolidation, further revenue losses could be expected. Both the option for businesses to join the common tax base and the absence of consolidation will provide significant scope for tax avoidance.

It is appropriate that consolidation should be required for companies choosing to accept a common base. Rules for consolidation, however, can be complex. Membership of a corporate group must be determined by some threshold of ownership or control. Rules must be put in place to deal with loss pools, capital costs and reserves when subsidiaries enter and exit the corporate group. Corporate reorganization rules that vary by member state are also affected. However, these complexities are not an impossible barrier to consolidation since many countries have dealt with these issues. Consolidation by corporate group, however, is a complex issue.

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[1] The small business sector (companies with less than $15 million in assets) comprises about a third of corporate taxable income. That implies a relatively high degree by which large companies allocate income across two provinces or more rather than operate separate corporations by province. See the Technical Committee on Business Taxation (1998)).

[2] Devereux and Loretz (2007) have estimated that an option to join the common base would reduce corporate tax revenues by 1 percent. A requirement to be subject to the common base would increase revenues by 8 percent.

The Formula

A common consolidated tax base will require the use of a formula. Various issues are involved, including whether the formula is specific or uniform across companies, specific to each jurisdiction and upon which factors will be chosen to apportion income to member states.

The Canadian and US formulary apportionment uses firm-based factors to divide the common tax base among sub-national governments. In Canada, the general formula is uniform among provinces, which requires corporations to allocate income to each provinces according to the shares of payroll and sales (destination basis), equally weighted. Special formulas apply to certain industries, primarily in finance and transportation. By and large, the provinces have agreed to use the same formula, which has been in place for about 60 years, despite some complaints especially by the resource-rich provinces who feel that the use of sales reduces the allocation of the tax base to them. In the US, most state governments had used the Massachusetts formula – equal weighting of sales, payroll and capital in the past; however, many have chosen other formulas now, with greater weighting of sales to encourage more employment in the state. Special formulas apply to some industries.

EU discussions are considering the Canadian-US approach to formulary apportionment but they have also toyed with the notion of a "macro-approach" whereby a formula would be based on economy-wide factors rather than based on the firm's characteristics. The benefit of a macro-approach is to reduce the scope for tax planning since the alternative encourages companies to shift labour and capital to low-tax rate jurisdictions in order to increase the allocation of income to these states (thereby providing a lower cost of capital and labour).[3] However, given companies have much different attachment to individual states that would not be reflected in a "macro" formula, the EU discussions are wisely being focused on the Canadian or US approach to formulary apportionment.

As for special formulas for certain industries, the EU discussions so far have not paid much attention to these questions except to note the need for a special formula to apply to financial companies. It shall find that other special formulas will be needed since labour, capital and sales are inadequate to split income not only in finance but also transportation and possibly telecommunications.

The most interesting question that will need to be addressed is determining the exact formula. The formula will affect how revenues are distributed across member states and the tax paid by a specific corporation. Greater reliance on origin-based factors – labour and capital – provides more revenues to those states with production. The use of sales, measured on a destination basis, provides more revenues to states with large consumer markets.

[3] See Mintz and Weiner (2003).

The EU has also considered the use of value-added – labour income and economic rents accruing to production – as a basis for splitting corporate income although the proposal is less likely to be adopted. Given the importance of value-added tax systems, this option is intriguing as a destination-based method of apportioning corporate income. However, value-added calculations under credit-invoice VAT is quite different than accounting-based calculations so it is not entirely clear how feasible value-added calculations would be to use in a formula without substantial complexity. However, one could consider measuring value-added similar to the Italian IRAP and Hungarian regional taxes, which then would be accounting and origin-based.

The use of payroll, capital and sales in the formula raise a number of issues that are being discussed by the EU member states.

Payroll is simplest to measure except for two specific considerations. The first is performance-based employment compensation since EU countries do not have the same treatment of stock options and some other forms of deferred compensation. The second is with respect to cross-border arrangements related to temporary employment and contract work. In the Canadian and US systems, no adjustment is made for employment transfers and contracting – I suspect it is not a major issue in terms of the distribution of revenues and tax planning, at least yet. These technical questions will need to be sorted out but it might be easiest to use payroll paid according to the primary place of employment. Some concern has been expressed in EU discussions that payroll should be adjusted for wage levels since low-wage countries might otherwise get a smaller share of the tax base. However, wages reflect productivity of factors, not just the cost of living, so adjustments are bound to hurt countries with higher skilled labour. Neither Canada nor the US adjust for differences in wage rates even though wage levels vary across jurisdictions, perhaps not as widely as Europe but still nevertheless significantly.

With respect to capital, the usual issues arise such as whether to include intangible assets and to make adjustments for lease assets. Inventories, intangibles and leases assets contribute to a highly mobile tax base that could influence the factor proportions easily. Probably it would be easiest to exclude intangibles and inventories since the assets are so mobile and focus instead on fixed property and equipment. On the other hand, adjustments to fixed asset calculations for leasing might be appropriate since companies could easily shift their assets into permanent establishments operating in low-tax jurisdictions to be leased to other jurisdictions. Again, much depends on how severe the problem shall be and whether the issue needs to be addressed. A further point of contention is whether to measure capital on a "flow" basis rather than "stock" basis as in the US formula. Gross investment flows reflect replacement of depreciated capital and new investment – flow measures would provide greater allocation of corporate profits to jurisdictions with more depreciable capital. Any asset sales would also reduce the flow measure and lead to potentially negative weights. Stock measures, net of accumulated depreciation, are thus superior conceptually. While it would be desirable to measure assets on a fair market basis, it is highly unlikely that values are easy to develop. Therefore, stock measures would rely mostly on book values for easier compliance.

As for sales being included in the formula, the EU discussions focus on whether origin or destination measures of sales should be used in the formula. If property and labour are already included in the formula, origin-based sales, which also includes intermediate factors, would change production shares somewhat when measuring profits on an origin basis. However, sales on a destination basis seem better to consider in the formula since the sales factor could adjust revenues in favour of consuming member states, making it easier to develop a final agreement.

Ultimately, the choice of factors will be critical in allocating the tax base that each government receives as well as the tax payments made by companies. Devereux and Loretz (2007) suggest, however, that the impacts would not be large using different formula. The hard part of reaching an agreement is choosing the formula since it becomes a zero-sum game among EU states in a static sense – any more allocated to one country reduces allocations to the rest. To the extent that a common corporate tax base leads to economic improvement, it is easier to achieve an agreement with selected factors since countries would share a growing tax base.

Non-Business Income

Most income tax systems, including Europe, distinguish between active, investment income and capital gains. Active income – business income more specifically – is arrived at by deducting costs from receipts derived in the course of regular trade or activity. Investment income, such as dividends and interest, and capital gains is taxable after allowing a deduction for costs related to the investment only (such as broker fees). For the purposes of formulary apportionment, Canada does not distinguish between business and non-business income while US states will allocate non-business income according to location of physical or intangible property or taxpayer domicile.

Distinguishing amongst different sources of income creates greater complexity compared to applying a single formula to the common tax base. It could also encourage greater tax planning if different approaches are taken. It seems that little justification can be given for separation of business and non-business income, at least in my view.

Inbound and Outbound Investment

A difficult issue facing EU member states in developing a common tax base relates to third party countries. Given the importance of the federal government in determining international tax policies, Canada and US deal relatively simply with outbound and inbound investments since the federal international tax rules generally apply uniformly to all sub-national governments. Canada levies a federal-only tax on income received from foreign affiliates by applying a federal rate that is 10 points higher than the rate applied to domestic income (more formerly, the federal rate is reduced by an abatement equal to 10 points for income allocated to a province). With respect to foreign portfolio income, the province applies its own tax if the income is earned by a permanent establishment operating there. The province will give a credit for foreign withholding taxes, similar to the federal government. US policy is similar to Canada in this respect as states tend to

follow federal rules. However, it can be more complicated if states choose to tax multinational on a different basis such as the famous California corporate tax levied on a formulary basis.

For the EU, however, the starting point is that each country has its own set of bilateral tax treaties and method used to tax foreign-source income earned by multinationals. Unless multilateral tax treaties are considered by the EU to bring harmonization among member states, the EU will be left to develop some other method to handle taxation of foreign source income and withholding taxes on payments to non-residents of third parties. One approach is simply to apply the common tax base to European source income only, leaving foreign-source income to be taxed according to where the permanent establishment resides. This could be an awkward approach, however, since it will require a clear allocation of income and expenses between domestic and foreign sources. Moreover, recent European Court of Justice cases (such as Cadbury Schweppes and Columbus Container Services) may impact on the use of deferral and passive income rules used by individual countries. EU states might look for a common approach to the taxation of foreign-source income if it becomes difficult to apply anything other than the exemption system within the EU.

Conclusions

Much work is left to do if the EU is to adopt a common consolidated company tax base. Progress has been made on a number of issues but many difficulties remain, especially in choosing the formula for dividing income among member states. Over time, however, I believe that governments and the business sector will realize that the integration of European economies leaves little choice but to harmonize company tax bases in some way.

COMPARISON OF APPORTIONMENT OR ALLOCATION METHODS FOR CORPORATE INCOME TAXATION

	United States	Canada	EU Proposals as of March 2007
Name Given	Apportionment	Allocation	Apportionment
Jurisdiction	States	Provinces	Member States
Tax Collection Agreement with Central Government	No	Yes for 7 provinces. Ontario joining system. Quebec and Alberta collect own corporate tax	No
Taxable Unit	Corporation	Corporation (publicly-traded trusts to have special formula to be determined)	Company
Jurisdiction for Taxation	Nexus – substantial connections of activities to the state and 1993 Geoffrey Ltd. Vs South Carolina provided for intangible property to have a connection (royalty income in Delaware)	Permanent establishment – fixed place of business	Permanent Establishment
Tax Base	Federal base with additions and subtractions by state to determine apportionment of base	Generally federal definition of income to determine allocation before application of credits	Common base using International Accounting Standards principles
Consolidation	Yes (unitary combination)	No	Not yet determined – will be optional to adopt a common base
Factors	Chosen by state so factors may not add up to 100% across all states – Massachusetts Common Formula (1/3 capital, payroll, sales) used by most states in 1957 Most double weight sales since 1977. -Special treatment of finance (financial assets or income), transportation (revenue miles), construction contractors, broadcasting and publishing	Generally common among all provinces based on average payroll and sales. Special treatment of transportation (revenue passenger miles), finance (loans and deposits) and insurance (premiums)	-Use payroll and/or employees, capital and sales Or value-added Or Macro-approach (latter two on standby) -special formula for finance, maybe others
- Sales	- destination basis using retail gross receipts -throwback rule for tangible personal property sales if not taxed in destination state	- destination basis using retail sales	-origin or destination basis to be used
- Labor	- payroll of employees including benefits	- payroll of employees	-payroll with possible adjustment for outsourcing and

			secondments
- Capital	- accumulated investment in tangible assets including inventory	None	-non-financial assets -tax value of assets, -consideration of lease and intangible assets
Non-business income	Allocated to specific states	Part of business income	Perhaps similar to the Canada
Foreign-source income	States can include worldwide income to determine allocation.	Tax at federal level only on business income. Investment income subject to provincial tax with credit for foreign tax.	Excluded from the common tax base or included under common rules subject to existing DTSs
Formula	Tax = Sum of tax rate x state weight x national income with weight being shares of factor in state to total in all states where company does business	Tax = Sum of provincial tax rate x provincial weight x national income with weight being shares of factor in province to total in all provinces where company does business	To be determined but likely similar in structure to the US and Canada

Sources: Weiner [2006] and European Commission [2007]

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