

# Editorial

## Common corporate consolidated tax base – don't forget the tax rates!

Professor Dr. Christoph Spengel, *University of Mannheim*<sup>1</sup>

### Tax obstacles to EU-wide economic activities

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

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

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%		

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 of the EC Treaty) since no efficient allocation of resources is guaranteed.

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 State prevails, double taxation may occur as a result of conflicting taxing rights. In particular:

- relief for losses incurred by associated companies located in other Member States is not allowed in many cases;

- the allocation of profits of multinationals to different jurisdictions on an arm's length basis by transfer prices causes methodological problems and results in double taxation;
- cross-border reorganizations give rise to capital gains taxation and bear the risks of double taxation in many situations.

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 capitalization rules, and CFC-legislation. These tax provisions may violate the fundamental freedoms of the EC Treaty (see ECJ judgments, e.g. *Marks & Spencer, X and Y, Lankhorst-Hohorst, Cadbury-Schweppes*). Without further tax coordination Member States presumably are not able to reform their tax systems so that they respect the fundamental freedoms for cross-border activities and do not destroy the systems of domestic company taxation at the same time.

### Options for a common tax base in the EU

At first glance, a harmonized 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. If CCCTB will be applied 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).

<sup>1</sup> Christoph Spengel is also Visting Professor at the Center for European Economic Research (ZEW) and a member of the Scientific Advisory Committee of the German Federal Ministry of Finance.

Table 2 Approaches to EU company taxation

Reduction/elimination of tax obstacles to cross-border EU-wide activities	Approaches to EU company taxation with different degree of international cooperation		
	- Harmonized tax base throughout the EU with one set of tax accounting principles	- Harmonized tax base throughout the EU with one set of tax accounting principles - Cross-border loss relief	- Harmonized 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
Reorganizations	Achieved But only if the tax treatment of reorganizations is harmonized	Achieved But only if the tax treatment of reorganizations is harmonized	Achieved But only if the tax treatment of reorganizations is harmonized
Double taxation as a result of conflicting taxing rights	Not achieved	Not achieved	Achieved

Finally, each Member State preserves the right to tax the allocated portion of the consolidated tax base by its own tax rate.

Although there is strong support for the idea of a CCCTB, it is, however, not clear whether such a harmonized tax base really corresponds to the original idea of a CCCTB. Three different interpretations of a harmonized 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).

The minimum degree is a harmonized 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.

A harmonized 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 of calculating the recovery if the loss is offset later in the country of incidence. Some mechanism for this is necessary if duplicated loss relief claims are to be prevented, as was emphasized in an earlier proposal for foreign loss relief by the European Commission.

In order fully to eliminate tax obstacles to cross-border EU-wide activities, 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.

A CCCBT raises a lot of questions. There is strong support to accept International Financial Reporting Standards as a starting point for the common tax base. In order to administrate such a system 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. At the European level, however, it should be restricted to corporations. Each Member State could then decide whether to grant partnerships access to the CCCTB. The definition of group should combine legal and economic criteria and group income should be consolidated on a broad basis (i.e. include all categories of income). Local profit taxes can be levied on the apportioned income in each Member State; therefore they do not reduce the consolidated group income. Finally, 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.

### **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.

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 by a minimum level for the 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 harmonized tax base combined with a minimum corporate tax rate serves as a compromise between economic efficiency in the EU and Member States tax autonomy.

### **Conclusion**

A CCCTB helps to reduce current tax obstacles to cross-border activities within in the EU. However, this only can be reached if the CCCBT 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 harmonization 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.