

Editorial

An optional and competitive common consolidated corporate tax base – a comprehensive measure towards a better functioning internal market

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In March 2000, the European Council launched the Lisbon Strategy, which sets the ambitious objective for the EU of becoming, by 2010, the most dynamic and competitive knowledge-based economy in the world. The fact that companies operating within the EU currently must manage up to 27 different and often overlapping tax jurisdictions constitutes a significant obstacle to accomplishing this objective.

In its comprehensive corporate tax study from 2001, 'Company taxation in the internal market', the European Commission already reached the conclusion that corporate taxation in Europe constitutes a significant obstacle to growth. The Commission examined 11,000 investment combinations in the European Union. Different owners, modes of financing, investment objects and group structures were included in the analysis. The numerous obstacles to cross-border investments were apparent. The study also showed the benefits of low tax rates and broad tax bases. Obviously, growth and economic efficiency could be vastly improved, to the benefit of European citizens, if tax obstacles could be removed or at least mitigated.

The study, however, did not include any quantitative measure of the impact of various tax policy measures on growth. Yet, judging from simulations using general equilibrium models in similar situations, streamlining the computation of taxable profits and eliminating economic double taxation for cross-border activities alone, could increase the national growth rate of the European economy by several tenth of a percentage point per annum. That would constitute a significant boost of the potential output of the European economy.¹

With such a higher growth rate and thereby higher employment levels, tax rates could be reduced, further enhancing the growth and employment potential of the European economy. These economic underpinnings were the driving forces behind the European Commission Services' initiative in 2004 to try to develop a comprehensive and competitive Common Consolidated Corporate Tax Base (CCCTB). The technical work has been undertaken in the most

professional manner, starting with an academic approach to tax principles and a comprehensive design of each element of a corporate tax base. To a large extent, the design of the corporate tax base mirrors the national discussions some hundred years ago when the current corporate tax systems evolved. Unfortunately, many countries have since made compromises and deviations to such an extent that the existing corporate tax systems typically violate many of the basic principles and now more often than not act as a hindrance to economic efficiency.

The current patchwork of national tax systems within the EU does not only bring double taxation and considerable tax uncertainty, but also large compliance costs and tax-related barriers to business restructuring. As a result, the EU is experiencing a large loss in economic efficiency. As pointed out by the Commission, removing these obstacles would facilitate new enterprises' entry into the market and spur investment and innovation. Simply stated, it would enhance the competitiveness of the EU economy.²

At the same time as governments reduce statutory corporate tax rates, their revenue authorities seem to be more and more eager to try to tax earnings from foreign affiliates within a group of companies. The costs which firms incur in dealing with conflicting national tax claims, as well as the lack of cross-border loss relief, have increased as businesses have become more internationally oriented. Business structures no longer follow national borders but tax authorities still judge any business model from its national revenue

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¹ On a similar note, studies examining cross-border flows suggest that on average, FDI increases by 3.7 per cent following a 1 percentage point decrease in the tax rate on FDI. See 'Tax Effects on Foreign Direct Investment', *Policy Brief* (OECD, February 2008).

² European Commission, *The Contribution of Taxation and Customs Policies to the Lisbon Strategy*, COM(2005) 532, p. 4.

implications. It has now reached the point where many multinational businesses are demanding to be taxed once, not twice or not at all, on their total profit. The cost of compliance is now so high that cross-border European investments are foregone. In the UK, the top four audit firms' earnings from tax services alone grew 19 per cent between 2004 and 2006, reaching over UKP1.6 billion. The bulk of the cost is however, within companies. The major cost to the society and citizens is the foregone investments and jobs in Europe.

The technical outline presented by the Commission has some very attractive features and two of these must be considered essential for any competitive tax system. The first is simplicity. Examples of this include the pooling-method for the depreciation of assets, the removal of transfer pricing problems for intra group transactions and a 'one-stop-shop' for administration and compliance. The other core aspect in providing a competitive system is the definition of the tax base *vis à vis* third countries. Traditionally, two concepts have been used to mark this 'water's edge' – Capital Export Neutrality (CEN) and Capital Import Neutrality (CIN).

European businesses need to be competitive in markets outside the European Union. For this reason, the CCCTB needs to allow European businesses to compete on an equal footing with domestic business in both large and developing markets outside the European arena. Therefore, the CCCTB would best serve the Lisbon objectives by following the principle of CIN. Such an approach would provide for a level playing field with respect to businesses located in third countries. It could also work to attract and strengthen the position of head offices within Europe.

A CCCTB based on CIN would also contribute to the simplicity of the tax system. In the technical outline, the Commission proposes that CIN is achieved through a CCCTB that provides for worldwide taxation with a double tax relief mechanism allowing for exemption of the foreign income. This is an attractive and competitive feature of the CCCTB. To the extent any anti-abuse measures are included in the CCCTB, they should be limited to the suggested switch-over mechanism to a credit method for income which has not been taxed at a corresponding corporate rate equal to 40 per cent of the EU average corporate tax rates, i.e. approximately 10 per cent. Such an anti-abuse measure is preferable to CFC or Thin Cap rules since such rules do not allow for competition in third countries on equal terms with purely national companies operating there. The Commission has furthermore, in a communication on anti-abuse measures, stressed the importance of limiting such measures to wholly artificial arrangements, stating that achieving a lower corporate tax burden is a legitimate business motive for location of business activities.³ This must be adhered to also with respect to the suggested switch-over mechanism.

Given the fact that not all Member States are likely to adopt the CCCTB from its inception, the extent to which the CCCTB will suffice to remedy the growth

obstacles, remains to be seen. It is obvious that only a comprehensive measure like the CCCTB can resolve all of the issues with transfer pricing, loss compensation and an equitable allocation of profits. If the CCCTB is correctly implemented, it could be a significant step forward in Europe. However, we do not know exactly how the system will look. It is too early to tell. The jury is still out and any final call on the CCCTB must wait until a concrete proposal is presented. It nevertheless looks very promising and the work undertaken so far by the Commission is very encouraging.

When it comes to the outcome it will depend on the actual specification of the system, how simple it is and how far countries are actually willing to rethink their strategy in corporate tax policy. To merit support from the business community at the end of the day, the key factors are that the system is optional for businesses; that it is consolidated from the start to insure taxation of net profits and that it is based on the concept of a one-stop-shop (filing in one location and with one tax authority as principal counterpart in tax matters).

To be competitive, the CCCTB must be comprehensive and exclusive and it must not involve tax rate harmonisation or the introduction of a minimum rate. In addition to the introduction of an optional CCCTB, governments need to take unilateral short-term measures and revert to sound good old tax principles, like those that have been re-emphasised in the Commissions' technical work on the CCCTB. As long as the US and Japan are not embracing similar principles, transfer pricing will unfortunately remain an issue and a cost. By making the CCCTB optional for businesses, governments can however allow for tax competition without companies actually having to move out of their jurisdiction. Being able to keep the business in their country should be seen as an advantage also for governments.

There is a further need to reduce corporate tax rates in Europe to make more investment opportunities viable but the elimination of economic double taxation should be given due consideration. Reverting to taxing profits only once, is a good way to boost investment and enhance employment opportunities. The CCCTB sets out to do just that based on the recognition that more investments and jobs are needed in Europe.

³ European Commission, COM(2007)785, 'The application of anti-abuse measures in the area of direct taxation – within the EU and its relations to third countries', 'The objective of minimising one's tax burden is in itself a valid commercial consideration as long as the arrangements entered into with a view to achieving it do not amount to artificial transfers of profits. In so far as taxpayers have not entered into abusive practices, MSs cannot hinder the exercise of the rights of freedom of movement simply because of lower levels of taxation in other MSs. This is the case even in respect of special favourable regimes in the other MSs tax systems'. (COM(2007) 785, p. 3.)