European Commission CC(C)TB Proposal - October 2016

1. The problem with the current system of corporate tax and the idea of unitary taxation

1.1 Treating group entities as separate

The discussion on how to tax corporate groups consisting of multiple entities and operating across borders goes back at least to the time of the League of Nations after WWI. From the 1970s onwards, entities of the same corporate group have been increasingly treated as separate entities for tax purposes.

Based on this separate entity criterion, countries have been applying the so-called arm's length principle (ALP) for the pricing of transactions between related parties. The ALP stipulates that contracts between related parties should be comparable to contracts between independent parties.

Since 1979, the OECD has developed 5 so-called transfer pricing methods to allow for a comparison of transactions between related parties to those of unrelated parties based on the functions, risks and assets employed.[1]

This system has however major shortcomings[2]:

- The underlying problem of the ALP is that related and unrelated parties are simply not comparable when it comes to the negotiation of contracts. Both prices and conditions of contracts are internally determined and are never the result of an independent negotiation.
- Treating contracts between related parties in the same way as legal contracts between independent parties is hence unrealistic and allows MNCs to contractually allocate functions, risks and assets in whichever place is most suitable for tax purposes.
- For many items traded within corporate groups (intellectual property, services, input parts in the value chain), there are no real comparable prices outside the firm. So the remedies developed with a view to coping with the lack of independence between related entities - the transfer pricing principles - lack their most fundamental input.
- In addition, the existing methods of transfer pricing are too complex, hard to monitor and enforce for tax administrations, and based on problematic data grounds. Databases of independent companies built on public commercial registries are inherently unreliable due to the limited number of countries contributing to such databases and the small selection of companies covered.
- Double tax treaties (OECD Model, but also, with minor differences, UN Model), generally applying residence (origin of capital) over source criteria (where activity takes place), end up putting more distance between the place where the economic activity takes place, and the place where it is taxed.
- Tax administrations can hardly tackle MNCs' aggressive tax planning because of the complexity of a system and their relative lack of resources compared to MNCs.

International reform efforts, mainly in and around the OECD/G20 BEPS Action Plan have recognised some of the weaknesses and the extent of profit shifting and base erosion taking place today, but have not moved beyond the ALP. The recommendations create more sophisticated and, in consequence, complex rules in the existing system which will not resolve the fundamental weaknesses outlined above; and some of which threaten to allow for more BEPS.

An alternative to the ALP system is unitary taxation, i.e. considering corporations as a single entity for tax purposes.

1.2 Unitary taxation (UT) with formula apportionment (FA)

[1] Lately, based on a methodology developed by Argentina, developing countries have started using more and more often what is known as the 6th method for valuing the export of commodities between related parties (using market quotes from international markets for that purpose).
[2] For an overview of these weaknesses, the options of unitary taxation and the impact of the OECD BEPS project, see Picciotto (2016)

With UT, all legal entities belonging to one corporate group consolidate their profits and losses in one group result. The total profit is then distributed (apportioned) between those jurisdictions where the corporate group operates according to a formula, which weighs different factors of economic activity (e.g. assets, labour, sales). This *formula apportionment* gives each jurisdiction a part of the total profits based on how active the group is in that territory and not based on how much profit the groups decides to report there. Each jurisdiction then applies its own tax rate on the apportioned profit.

In principle, this system taxes corporations' actual economic activity and could limit profit shifting as profits are now reported globally and no longer in individual jurisdictions (to which they are currently being shifted for tax reasons). It could also break with the current paradigm of residence-based taxation and attribute more taxing rights to jurisdictions where production and consumption take place as compared to those where large MNCs are headquartered. By potentially reducing the complexity of tax rules, it could also help tax administrations facing resource and capacity constraints to better monitor and enforce those rules.

The system has already been applied in the US at sub-federal level (by 20 states) since the 1920s and also in Canada and Switzerland. During the 70s and 80s, some American states even extended it to cover global profits but lobbying by European MNCs and pressure from the US federal level restricted the system again to intra-US profits only[3].

Factors that should be used in formula according to Picciotto (2016):

- Assets: all fixed, tangible property - intangible assets are not to be included; they cause massive problems in the current system and are not necessary for the unitary approach as the entire income generated by the entire company is looked at and not its different affiliates.
- Labour: labour employed by company; can either use payroll or headcount (US has payroll system, EU proposes to adopt a 50-50 approach; payroll system problematic in low wage countries).
- Sales: sales made outside of the company, allocated according to the country of the recipient (destination principle) or based on a split between origin and destination.

Problematically, there are no international recognised tax accounting rules on which a UT system could be built. Murphy & Sikka 2015 argue that financial reporting standards (such as IFRS) are a bad proxy for determining tax liabilities as they contain too many subjectively set variables (such as market values of assets and expected future cash flows).

National accounts based on national rules could in principle be aggregated or gross revenues been apportioned globally for individual jurisdictions to apply their own rules on deductions after having received their respective share. Murphy (2016) also proposes the concept of an Alternative Minimum Corporate Taxation as a short-term alternative to full UT.

Further, there has been debate about the extent to which wide international cooperation is a prerequisite for moving towards a UT system (IMF 2014). One crucial impediment is the lack of funding, resources and political standing of the UN Tax Committee which would otherwise be in a position to take the lead on an international agreed corporate tax reform in an inclusive context with equal voting rights for all countries - in contrast to the much more limited OECD setting currently preferred by rich countries.

For this reason, it has been argued that if one or several larger economies can in fact introduce a system unilaterally and require global consolidated accounts in their jurisdictions; the ensuing double taxation could possibly create pressure for others to join the system as well.

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[3] Clausing 2014 (summary on TJN Blog) finds that the US system is simpler and helps curb tax base erosion. There are still challenges relating for instance to the definition of a consolidated group. The formula factors employment, investment and sales have been quite insensitive to the level of taxation in different US states. One qualification: corporate tax rates are in general low in states, which might contribute to this insensitivity. In the US, general trend away from equal weighting towards heavy sales weighting (according to Clausing, this has mostly happened due to the successful lobby attempts of business).

1.3 Problems with UT

Whether a UT system can actually improve tax justice depends on its specific design (e.g. EU CCCTB discussed below). Relinquishing national autonomy over corporate taxation in a context where decisions in international fora are heavily influenced by business interests may lead to worse outcomes independently of the theoretical merits of the UT system. Some potential problems are:

- Delineating a particular unitary corporate group gives businesses substantial latitude to determine where particular components will and will not be subject to taxation.[45]
- By consolidating losses and profits of a group across borders, one objective of current profit shifting practices could in fact happen directly and automatically for all companies[6]; allowing, all else being equal, for a smaller tax base overall[7].
- The internationally harmonised rules for calculating the tax base, which would come as a precondition of introducing UT, would limit jurisdictions' ability to apply more stringent rules locally and could hence shrink their tax base.
- Equally, there would be a risk of incompatibility with specific national existing regimes that apply different rules for calculating the tax base - e.g. local taxes in Italy or Germany not only based on profits (Gewerbesteuer).
- Depending on the concrete apportionment formula chosen, some jurisdictions that are not tax havens may still lose out in terms of taxable base. (IMF 2014).
- Tax competition around tax rates would continue if no form of minimum rates is introduced.
- As profits (before apportionment) are calculated globally, there would also be room for competition between jurisdictions on who offers the least control through tax authorities. This could in principle be mitigated by fully public CBCR and sufficient cooperation between all involved tax authorities.

1.4 Other forms of UT

As FA-based systems are still prone to shifting of those factors with strong weight in the formula, several authors argue that a heavy emphasis on sales in the formula is justified (e.g. formulary profit split in Avi-Yonah et al. 2009). Sales are in principle impossible to shift, if the calculation is based on the residence of customers and not some virtual place of contract (e.g. with online sales).[8]

The profit split method is already one of the OECD's recommended methods. However, it is used generally on the residual level (after apportioning profits to other group entities through the transactional net margin method to transactions in non-intangible intensive business segments). The FA-part of the system is only applied to the additional (residual) profits made through intangibles.

Proposals around **destination-based cash flow taxation** (**DBCFT** - e.g. Devereux and Vella 2014 and 2014b and Devereux, Auerbach and Simpson – very brief summary also in IMF 2014) more fundamentally alter taxation of

[4] Durst (2013), cited by David Spencer (2016) "Picciotto's Dilemma: What is Unitary Taxation?"
[5] No existing definition of corporate group includes companies that are in practice related because they share directors or shareholders (below a certain threshold of ownership). Thus, some cases exposed in Panama Papers will not be subject to UT in any scenario. However, countries do on occasions have wide consideration for "related transactions"; e.g. those taking place with exclusive distributors, or between companies sharing the same directors.
[6] Cross-border offsetting of losses is currently only allowed with limits. In the EU, for instance, the ECJ ruled in 2005 in a case brought up Marks and Spencer that MS cannot in a principled manner forbid the cross-border offset of losses as this infringes on the freedom of establishment. The ruling however did allow for a regulation of such loss offsetting. It could for instance be forbidden if there is any prospect of those losses being claimed for tax purposes in the future in the state where they originate. See here for more info.
[7] Profit shifting currently occurs to first offset losses in one country against profits in another in order to minimise tax payments. This would be done automatically under UT. The other main aim of profit shifting, to move net profits to low tax jurisdictions, would however be made impossible with UT which is why the overall effect on the total tax base can be expected to be positive.
[8] The experience in the US has been that most states have moved to a sales formula.

corporate income away from the source/residence dichotomy towards taxing at destination. Ciu 2015 argues that destination-based models suffer from an information problem with respect to the residence of customers (needed to establish the final destination of sales) and that, instead, the residence-based taxation model should be altered by redefining residence as the place of residence of shareholders (assuming that information about the residence of holders of financial instruments is more generally available than information about the residence of customers of goods and services) rather than the place of incorporation of a company as currently the case[9].

A third UT alternative, next to formula apportionment and DBCFT, would be **residence-based worldwide taxation (RBWT)** where MNCs would be tax liable in their jurisdiction of residence for their worldwide income minus any taxes already effectively paid by foreign subsidiaries in their respective jurisdictions of residence (Picciotto 2016, p. 22, for overview). This concept is equal to full-inclusion controlled foreign company (CFC) rules. As residence of MNCs is also increasingly hard to define and/or easy to manipulate, the residence of (a majority of) shareholders could be alternatively employed.

Both the DBCFT and RBWT are however reinforcing the current tendency against source taxation and have therefore important downsides. Moving back towards source taxation (a claim of developing countries), could equally yield fairer global taxation. Source taxation directly relates to the place where activity taxes place but it has been increasingly discredited by the alleged double-taxation agenda.

2. The European Commission's CC(C)TB proposals

The Commission has put forward an initiative to reform corporate taxation in the EU. This initiative is a follow up to the Commission's 2011 proposal for a CCCTB[10]. The new proposal lays out a two stage process. Stage one endeavours to establish a common corporate tax base (CCTB) across the EU. The second stage aims at introducing a common consolidated corporate tax base (CCCTB) at EU level. The CCCTB will be negotiated as soon as the CCTB is politically agreed in the Council.

2.1 The CCTB proposal

- Harmonises calculation of corporate tax base in all EU MS while MS would still to set their own tax rates
- Mandatory for corporate groups with more than 750m euro global turnover (smaller ones can opt in) – an entity is considered part of a group above 50% voting rights and 75% capital ownership or profit distribution. (Art 2/3)
- Introduces the OECD BEPS permanent establishment (PE) definition, but only EU-based PEs from EU taxpayers are subject to the rules. EU-based PEs of non-EU taxpayers and non-EU PEs from EU taxpayers are left to national laws and bilateral treaties. (Art 5)
- Calculation of the tax base is laid out in Chapter II of the proposal. All income that is not explicitly exempt is taxable. Exemptions include (Art 8):
    - Proceeds from dividends or the disposal of shares, given that the company has had a minimum holding of 10% in capital or voting rights of the company for 12 consecutive months.
    - Profits from PEs are subject to tax in the state of location of the PE and exempt in the state of the company's headquarter.
- Generally all costs incurred to obtain income and run the business are tax deductible. Other specific deductions include:

[9] For a comparison of consumption and DBCFT, see Auerbach and Devereux (2013).

[10] The 2011 CCCTB proposal is in many parts similar to the proposals presented in 2016. It was however conceived as an optional choice for firms operating in the common market as its main underlying agenda was promoting ease of doing business and not fighting tax avoidance. It was criticised (e.g. by FES for not being mandatory, not featuring minimum rates and other weaknesses) Because of strong opposition from many MS, in particular against consolidation, the proposal did not find agreement in five years of negotiations in the Council. The EP had voted its position in 2012 already calling for the CCCTB to be mandatory and feature a minimum rate of 70% of the EU average.

- "R&D super deduction" (Art 9): R&D Costs can be fully deducted, plus adding a 50% of extra R&D costs for deductions below € 20m and 25% of R&D costs above €20m[11]. Less than 5 year old start-ups are allowed to deduct 100% of R&D costs below 20m if they have less than 50 employees, less than €10m turnover, no associated enterprises and not been formed through a merger.[12]
    - "Allowance for Growth and Investment" (Art 11): Notional yield on increases in equity will be deductible subject to anti-avoidance conditions. If equity decreases, a notional yield on this decrease is added to the tax liability.
    - Depreciation (Chapter IV, Art 30-40): Long- and medium-life fixed tangible and intangible assets are depreciated individually and all other depreciable assets are placed in a pool.
- Some items are specifically non-deductible (Art 12), e.g. profit distributions, retained earnings to equity, fines and penalties, losses from PE in third country.
- Treatment of losses (Chapter V):
    - Losses in a given year can be carried forward indefinitely to subsequent years unless the taxpayer is bought up by another company or changes substantially its activities. Losses cannot be carried back.
    - Losses carried forward cannot lead to a negative tax base. When carrying losses forward, oldest losses are always considered first.
    - Losses from immediate subsidiaries or PEs can be offset at parent level cross-border. As soon as the subsidiary of PE subsequently makes profits, those are also attributed to the parent. If no profits are made within 5 years or the subsidiary is sold or wound up, hitherto deducted losses are added again to parent's tax liability.
- Rules agreed in the anti-tax avoidance directive (ATAD) in June 2016 now become harmonised EU rules (rather than minimum standards beyond which MS can set their own (stricter) rules as was the case in original ATAD), intended to be applied particularly in relation to non-EU MS.[13]
    - Interest limitation rule (Art 13), exit taxation (Art 29), switch-over clause (Art 53), general anti-avoidance rule (GAAR) (Art 58), CFC rule (Art 59), hybrid mismatches (Art 61).

2.2 The CCCTB Proposal

- Uses rules laid down in CCTB and adds consolidation and apportionment of profits across MS where group operates. Intra-group transactions are ignored for consolidation purposes.
- The apportionment formula consists of three equally weighted factors: assets, labour and sales. Each enter with one third in the apportionment formula. An alternative apportionment method can be used in exceptional circumstances and if all involved MS authorities agree.
    - The labour share is equally subdivided into headcount and payroll.
    - The asset share only comprises tangible assets and excludes intangibles and financial assets.
    - The sales share is based on the destination of sales. If sales are made in a MS or third country without group member, the respective shared is split among all other group members according to their respective asset and labour shares.
- Specific rule for the calculation of the apportionment are laid down for financial and insurance undertakings, oil and gas companies and shipping, inland waterway transport and air transport companies.
- Consolidated losses are not apportioned but set off against future consolidated profits.

[11] Following the Commission's own example, this means, for instance, that €30m of R&D costs can lead to tax deductions of €42.5m or more than 140% of costs.

[12] These R&D super deductions have been included in an attempt to reduce patent-box incentives. National patent boxes would no longer be available to businesses for which the common base will be compulsory and to all other companies that would opt in.

[13] MS could still apply stricter anti-abuse rules to companies that are not obliged to apply the common base and do not opt into the system.

2.3 Assessment - CC(C)TB proposals:

- Given the obvious and systematic weaknesses of the current system of international corporate taxation based on the independent entity principle and transfer pricing at arm's length, an alternative that sets less complex but robust rules and allows for taxation of companies where they have economic substance is necessary to fight tax avoidance and enable tax authorities to enforce rules effectively also against large MNCs. The CCCTB can be a useful tool to this end.
- The Commission proposals are however conceived not only as a tool against tax avoidance but also as a mechanism to promote business and lower administrative costs in the EU's common market.
- At closer observation, they contain several worrying provisions that could reduce the effective level of corporate taxation further and, in addition, significantly limit the capacity of EU member states to fight tax avoidance unilaterally if necessary.
- The decision to split the proposal in two will make agreement on the CCTB more likely but may delay agreement on the necessary consolidation part indefinitely as some member states have already announced fierce resistance and the similar 2011 proposal remained stuck in the Council for five years.

Scenario 1: If a CCTB is adopted without a consolidation element:

- Preferential arrangements for attracting corporate profits (patent boxes, tax rulings, and country-specific regimes like Belgian notional interest deduction or Double Irish) are harder to offer but this may intensify the race to the bottom of corporate tax rates in the EU as tax bases become more easily comparable and the main tool of tax competition.
- Profit shifting via intra-company trading under the arm's length principle will not cease.
- Loss offsetting across borders will reduce overall corporate taxation.
- Despite the CCTB setting harmonised rules for tax accounting for large EU businesses, there is still a risk of accounting arbitrage due to inherent problems with International Financial Reporting Standards (IFRS) often used as basis, national transposition and the interplay with different rules for smaller companies as well as those outside the EU.[14]
- The OECD BEPS permanent establishment (PE) definition is introduced, which still contains weaknesses and does not address all types of PEs.[15]
- Minimum anti-avoidance standards in the ATAD are turned into absolute EU rules. This would prevent member states from going beyond those weak solutions to tackle BEPS for those multinationals to which the CCTB applies.[16] Some ATAD provisions, like CFC rules, are however improved to roughly the standard of the original Commission proposal and thus better than the watered-down version agreed by the Council in June 2016. Hybrid mismatches now also cover third country situations, which is positive, in particular for developing countries. The switchover clause, originally also proposed by the Commission but dropped by the Council is re-introduced.
- The R&D super deduction aims at replacing patent boxes by allowing for more deduction of R&D expenses, based on the assumption that expenses are a closer reflection of the reality of the economic activity. However, contractual allocation of expenses can also be problematic and the super deduction may lead to significantly lower corporate tax revenues than with current rules and no harmful patent boxes.
- The allowance for equity deductibility based on the growth and investment allowance is better than the notorious Belgian notional interest deduction scheme but tries to rebalance the debt-equity bias by providing more advantages to equity instead of reducing those attributed to debt financing, hence also reducing overall corporate tax intake. In addition, providing tax incentives based on equity may add to already existing systemic stability risks, particularly in the financial sector.

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[14] See comments to CC(C)TB by Richard Murphy
[15] See BEPS Monitoring Group's comments on the PE proposal of BEPS Action Plan.
[16] See De Masi (2016) for a detailed analysis of the ATAD proposal and outcome.

- Equally, the rules for the deductibility of dividends and the proceeds from the sale of shares are more generous than currently existing rules in several MS and would lower corporate tax revenues overall.

Scenario 2: If the full CCCTB is introduced as proposed:

- The race to the bottom of corporate tax rates in the EU may continue even without profit shifting[17].
- The proposed formula still has room for improvement. Sales are by destination only, when a split between origin and destination could be suggested. Also, the lack of EU generally accepted accounting standards can affect the formula, giving room for arbitraging formulas (See Sikka and Murphy, 2015).
- There further is a risk of factor shifting instead of profit shifting as companies try to minimise their tax liability given a certain formula (e.g. valuation of certain assets or posting of workers employed through subsidiaries in low tax states).
- The CCCTB does not solve the problems of transfer mispricing globally: it simply seeks to address it within the European Union. As the proposals are limited to operations of EU taxpayers in the EU, much of the current problematic system of corporate taxation will remain existent – outside the EU, in the interaction of EU companies with third countries and even within the EU for companies below the €750m threshold[18] or those that are not tax resident here but still do business.
- There is still potential for tax planning between factually related companies as the definition of corporate groups is very narrow. A company can receive just under 75% of profits from a subsidiary or hold 49% of voting rights without that subsidiary being counted as part of the group. Even the OECD model treaty foresees the application of the ALP as of 20% participation, and some MS have even lower thresholds, e.g. Portugal has 10 % participation.
- For both previous points (€750m and 50%/75% thresholds), there are incentives for corporations to split their business in parts that remain just under the thresholds.
- Also there is a risk that companies are linked and/or controlled through means different than formal (majority) ownership. As in the case of IKEA and others, several family members own different, legally separate parts of the same conglomerate which is centrally managed and should therefore be treated as one entity under the CCCTB.

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[17] Generally, the notion of tax competition between jurisdictions makes no sense economically, even in a liberal conception. It is regularly said that tax rates could be seen as a market price for the provision of public goods and that jurisdictions that offer better services at a lower price (tax rate) would rightfully attract more business (customers). This is however profoundly flawed in the context of significant (fiscal) externalities – on public budgets and hence the entire society/economy of a jurisdiction - from changes in tax rates (Wrede 1997 or Buettner 2001 for empirical evidence from German local tax competition prior to the introduction of minimum rates on locally set business taxes). Unhindered tax competition of jurisdictions for mobile capital will hence always result in inefficient allocation outcomes.

[18] In this context, a company with significant business of 700m euros in 20 EU member states and considerable profit shifting would not be subject to the new system (unlike a company with global turnover of 800m euros, but only a minor presence in the EU). In addition, companies just around the threshold could move back and forth between the CC(C)TB and national systems, for instance first taking advantage of the R&D super deduction in terms of deductible expenses and then, after opting-out again, allocating income received from R&D to a preferential national patent box.

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